



Annual Report & Accounts 2018

Bringing resources to life



**Registered Number:
2366640**

**As one of the largest
FTSE 250 environmental
infrastructure groups in
the UK, Pennon has assets
of around £6.2 billion and
a workforce of around
5,000 people.**

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/annualreport2018

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 have integrated our reporting on financial, economic, social and environmental aspects of our performance and how they contribute to long-term value creation. In preparing this integrated report, we have referred to the principles of the International Integrated Reporting Council's International <IR> Framework.

Our vision

Bringing resources to life

Our values

Trusted

We do the right thing for our customers and stakeholders

Responsible

We keep our promises to our customers, communities and each other

Collaborative

We forge strong relationships, working together to make a positive impact

Progressive

We are always looking for new ways to improve and make life better

 READ MORE ON PAGES 09 AND 26

Strategic priorities



**Leadership
in UK water
and waste**



**Leadership
in cost base
efficiency**



**Driving
sustainable
growth**

 READ MORE ON PAGES 16 AND 17

Our core businesses

Pennon provides services in waste management, water and wastewater, and water retail services through our three businesses Viridor, South West Water and Pennon Water Services.

**Waste
management**

**Water and
wastewater**

**Water retail
services**

 READ MORE ON PAGES 28 TO 41

 READ MORE ONLINE
www.pennon-group.co.uk/our-core-businesses

**We aim to protect the
environment while
providing outstanding
service to customers**

OVERVIEW

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Our business at a glance

We aim to provide an outstanding level of service to our customers and communities, while protecting the environment and creating value for our shareholders.

Water and wastewater

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

 READ MORE ON PAGES 34 TO 40

- 1 Raw water reservoirs/
water resources
- 2 Upstream catchment
- 3 Water treatment works
- 4 Drinking water
mains network
- 5 Surface water catchment
- 6 Customer support
- 7 Wastewater mains
network
- 8 Wastewater treatment
works
- 9 Sewage sludge/
bio-resources
- 10 Improve bathing and
shellfish water quality

Waste management

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

 **READ MORE ON PAGES 28 TO 33**

- 11** A fleet of waste collection vehicles
- 12** Energy recovery facilities (ERFs)
- 13** Household waste recycling centres (HWRCs)
- 14** Materials recycling facilities (MRFs)
- 15** Powering homes and businesses
- 16** Landfill sites and power generation
- 17** Trading recycled materials

Water retail services

Business water specialists providing water retail services for all business customers' water management needs.

 **READ MORE ON PAGE 41**

- 18** UK-based customer service centre

Group highlights

Financial

Highlights of the year

- Good performance in cost base efficiency
 - South West Water total expenditure (totex) efficiency K6 to date £177 million
 - Final phase of Bournemouth Water integration complete: on track to deliver K6 cost savings of £27 million
 - £13 million of Group-wide efficiencies secured to date, including integration of a Group-wide IT platform. On track to deliver £17 million by 2019
- Delivered £124 million of EBITDA from energy recovery facilities (ERFs)
- Continued sector-leading return on regulated equity at a cumulative rate of 11.8%
- Strong earnings growth across the Group
- £398 million of capital investment in sustainable growth projects
- Perpetual capital securities issuance delivering balance sheet flexibility
- Group remains well funded with low-cost efficient long-term financing
- Launch of pioneering sustainable financing framework
- Continued delivery of long-established 10-year sector-leading dividend policy to 2020 supported by earnings growth.

 READ MORE ON PAGES 42 TO 51

Revenue statutory
£1,396m
2016/17: £1,353m (+3.2%)

EBITDA statutory
£513m
2016/17: £475m (+7.9%)

EBITDA underlying⁽¹⁾
£510m
2016/17: £486m (+4.9%)

Profit before tax statutory
£263m
2016/17: £211m (+24.9%)

Profit before tax underlying⁽¹⁾
£259m
2016/17: £250m (+3.5%)

Average interest rate
3.7%
2016/17: 3.4% (+0.3pts)

EPS statutory
48.0p
2016/17: 39.8p (+20.6%)

EPS underlying⁽¹⁾
50.9p
2016/17: 47.0p (+8.3%)

Dividend
38.59p
2016/17: 35.96p (+7.3%)

Capital investment
£398m
2016/17: £385m (+3.5%)

Shareholder profits⁽¹⁾

	£m
Profit before tax and non-underlying items	259
Non-underlying items before tax	4
Statutory profit before tax	263
Tax charge	(4)
Profit attributable to perpetual capital holders	(21)
Profit after tax attributable to shareholders	201

(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.

Operational and sustainability⁽²⁾

Highlights of the year

- ERFs continued to perform well with average availability of 92%⁽³⁾ and operational ERFs delivering in excess of base case expectations
- Three ERFs in commissioning:
 - At Glasgow's Recycling and Renewable Energy Centre the materials recycling facility and anaerobic digestion facility have operated throughout the period and commissioning is underway for the advanced combustion facility
 - Dunbar contributing financially⁽⁵⁾ in line with expectations. Commissioning continues to progress
 - South London (Beddington) commissioning nearing completion
- Avonmouth ERF construction on schedule and budget
- Long-term partnership with Greater Manchester Waste Disposal Authority continues – positive outcome reached
- Recycling markets challenging with operating costs increasing to meet quality demands. Self-help measures continue. Developing new Asian markets, partially mitigating impacts of China's changing quality requirements
- Continued strong performance in water, with customers at the heart of our delivery plans:
 - Overall operational performance ahead of our commitments despite challenges from severe weather experienced in the region
 - £79 million of benefits identified to share with customers since 2015 through our unique WaterShare mechanism
 - Extensive customer research and engagement ahead of Price Review 2019 (PR19)
- Pennon Water Services has achieved net growth in the new competitive non-household market. Focused on value enhancing contracts
- Successful launch of HomeSafe programme
- New vision and values developed.

 **READ MORE ON PAGES 26 TO 41**

(2) Further commentary on these highlights and metrics is provided in the sections Our people (pages 26 and 27) and Our operations (pages 28 to 41).

(3) Weighted by capacity, excludes Bolton, includes JVs at 100%.

(4) Gigawatt hours, being an amount of energy equivalent to delivering 1 billion watts of power for a period of one hour.

(5) Reflecting liquidated damages.

Total low-carbon energy generation
1,560GWh⁽⁴⁾
2016/17: 1,549GWh (+0.7%)

Average ERF availability⁽³⁾
92%
2016/17: >90%

Recycling volumes traded (tonnes)
1.4m
2016/17: 1.6m (-12.5%)

Total waste material inputs (tonnes)
7.0m
2016/17: 7.6m (-7.9%)

Lost time injuries
89
2016: 124 (-28.2%)

Drinking water quality South West Water
99.96%
2016: 99.96% (unchanged)

Drinking water quality Bournemouth Water
99.98%
2016: 99.98% (unchanged)

Bathing water compliance ('sufficient quality' or higher)
97.9%
2016: 98.6% (-0.7pts)

Chairman's statement

Sir John Parker
Chairman

“Pennon’s record demonstrates that the Board is behaving in a responsible way to our customers, our workforce, our suppliers and our shareholders.”

Dear Shareholder

The Group is once again reporting a strong year. In the water business, strong operational and financial performance underpinned our sector-leading return on regulated equity (RoRE). In our waste operations, the Group made good progress towards bringing Viridor’s remaining energy recovery facilities (ERFs) on stream.

Across the Group, we delivered high levels of service to our customers, and improved the quality of our communication and engagement with both them and our workforce. Our unified structure is operating well, having brought together all aspects of the Group under Pennon, providing a clear line of sight operationally and strategically into South West Water, Viridor and Pennon Water Services. I particularly welcome the way we have delivered improvements in safety and environmental incident management over the past year. Our new vision and values emphasise to employees and external stakeholders that we strive to be a trusted and responsible company delivering high-quality, resilient services in a safe, reliable and sustainable manner.

Our success, however, needs to be viewed in a broader social and political context. The Government has expressed concern about certain behaviours displayed by some water companies and Ofwat is looking to address these. Work needs to be done to restore trust and confidence in the sector and we fully support Ofwat’s agenda of reform. I am pleased to report that South West Water is already carrying out its business in line with the improvements outlined. We remain committed to transparency, independent governance and sharing financial outperformance with our customers.

The Group’s final dividend of 26.62 pence per share is an increase of 7.0% and continues our 10-year, sector-leading dividend policy to 2020 of retail price index plus 4% year-on-year growth. Dividends per share are expected to almost double over the 10 years of the policy. In addition, we continue to share our success with customers through South West Water’s innovative WaterShare mechanism with £79 million of total cumulative benefits identified since 2015 to be shared through future bill reductions, service improvements and reinvestment.

Safety

The Group treats the issue of safety very seriously and has taken steps to enhance its performance in this crucial area with the injection of fresh expertise at both board and executive level.

28.2%

89

Lost time injuries 2017

158

number of apprenticeships which started in 2017/18

Jon Butterworth was appointed as a new independent non-executive director of South West Water in September 2017. In the role of independent scrutineer of health and safety processes across the Group, he is giving us the benefit of his years of operational and safety experience gained in the electricity and gas industry. Jon attends Pennon's main Board meetings, where safety continues to be the first item for discussion on the agenda. During the year, our director of Health, Safety, Security and Assurance continued to lead the development of our HomeSafe programme, which is designed to deliver the highest standards of health and safety performance (see page 26 for further details). The Board has given its wholehearted support to HomeSafe which commenced Group-wide roll-out in April 2018, following the successful completion of pilots at South West Water and Viridor.

Employees and culture

I firmly believe organisations that embody a clear sense of vision and purpose deliver significant, measurable results. Such organisations acquire and retain the best employees, deliver the most for customers, attract the best clients and increase returns for shareholders. With that in mind, I would like to take the opportunity to thank all our employees for their dedication and hard work in serving our customers, communities and other stakeholders during 2017/18 particularly during the severe weather experienced in March 2018.

Following last year's appointment of a Group director of HR, we are seeing a refreshed dialogue with our workforce through a variety of initiatives. Our first Group-wide integrated employee survey has given us a tool for benchmarking Pennon's workplace culture against other companies and is discussed further on page 26. The most successful workplace cultures are built on trust

and this is a key driver of engagement. Our corporate value of 'trusted' has particular resonance for all our stakeholders. Respect for human rights is incorporated into our employment practices and our values (see the Directors' report on page 103 for more details).

We have retained our emphasis on attracting graduates and offering apprenticeships while recognising the need to continually train and develop our people in line with best practice. The Government's new apprenticeship standards mean that apprenticeships are now on offer at all stages of the employee development lifecycle, from entry level through to executive level, and we are launching a range of new programmes in areas such as project management and engineering. Of particular note this year has been the six-fold growth in apprenticeships across the Group.

The most successful workplace cultures are built on trust.

Sustainability

As one of the UK's largest environmental infrastructure groups, we take our responsibilities to the environment and communities in which we operate very seriously. Customers expect us to deliver a variety of critical services – clean and safe drinking water, reliable removal and disposal of wastewater, recycling, energy recovery and the safe handling and landfill disposal of waste. Performing all of this to the benefit of the various communities we serve throughout the UK, and providing the consistent investment that underwrites this activity, amounts to a significant social contribution.

Bringing resources to life

Given our closer working across Pennon as part of the Group's evolutionary development, we reviewed the different visions and values in place across the Group and devised a new single vision – Bringing resources to life – with strong supporting values of 'trusted, responsible, collaborative and progressive'. Involving extensive input from our employees, our new vision and values build on the Group's strengths and will help drive our strategic priorities over the long term.

Our new vision and values also resonate with all our stakeholders, both internal and external. It is our job as a Board to set the tone from the top and to live up to our values consistently and with integrity and transparency. Pennon is building the Group into a trusted entity wherever we work within local communities and across the UK.

Trusted

We do the right thing for our customers and stakeholders

Collaborative

We forge strong relationships, working together to make a positive impact

Responsible

We keep our promises to our customers, communities and each other

Progressive

We are always looking for new ways to improve and make life better

Chairman's statement

continued

Pennon is pioneering a sustainable financing framework to integrate commitments to environmental and social objectives or expenditure into a variety of funding opportunities across the Group (see pages 42 and 49 for further information).

As a sustainable business, we seek continuous improvement in our waste management operations, in our water and wastewater services and in our ability to manage environmental incidents. Our director of Environment and Sustainability, who was appointed last year, is helping us to address environmental issues. There has been significant investment already in mitigating the risk of flooding and pollution and I am confident the Group will maintain this momentum.

Our new governance structure has bedded in well and we have continued to refine Board processes.

Pennon's record demonstrates that the Board is behaving in a responsible way to all our stakeholders, including our customers, our workforce, our suppliers and our shareholders. We are maintaining high levels of investment to ensure customers receive the best possible service, while controlling bills to households and providing support and assistance to those customers in vulnerable circumstances.

We are a key employer in the South West and nationally and continue to invest in our people. We are delivering appropriate rewards to shareholders, a significant number being our employees, many of whom are residents of the South West, and pension funds that will help to provide financial security to members of the public in retirement. We believe this represents responsible leadership and will continue to behave in a manner that reflects our values.

Board changes

In line with governance best practice, Martin Angle, Non-Executive Director and chairman of the Remuneration Committee, who has been a Director for nine years, will stand down from the Board on 31 December 2018. The Board plans to make an announcement about a successor shortly. In order to allow a period of continuity with a replacement, Martin will stand for reappointment at the AGM on 5 July 2018. I would like to thank Martin for his considerable contribution to the Group's success and strong governance over the years.

During the year, South West Water appointed Jon Butterworth as a new independent non-executive director and Matthew Taylor as senior independent director. While Jon and Matthew's roles are with South West Water, under Pennon's governance structure they and their colleague Martin Hagen, South West Water's third independent non-executive director, attend the Pennon Board and are encouraged to contribute to a range of issues from a South West Water perspective.

Governance

Our new governance structure has bedded in well and we have continued to refine Board processes. All our independent Non-Executive Directors have clear line of sight into South West Water, Viridor and Pennon Water Services. As we look to another year of operations, I welcome the way the new Group Board structure and the Pennon Executive have settled into what I believe is an efficient and effective organisation in which we can deploy the full strengths of our independent Directors. The executive teams at South West Water, Viridor and Pennon Water Services have also shown dedication, drive and enthusiasm, and their transparency with the Board has been a highlight.

Diversity

The Board and Group actively promote equality and diversity in the workplace and we have approved a new Group diversity and inclusion policy. We are committed to the search for Board candidates being conducted (and appointments being made) on merit and with due regard for the benefits of gender and ethnic diversity. The November 2017 Hampton-Alexander Review: FTSE Women Leaders listed Pennon at number 40 in its FTSE 250 rankings for women on boards and in leadership, with a score of 33.3%. Both Chris Loughlin and I are members of the 30% Club, a forum with a goal of achieving a minimum of 30% women on FTSE 350 boards by 2020.

 [READ MORE ON PAGE 81](#)

Outlook: building success, earning trust

There are many reasons why Pennon is well placed for the future. Confidence in our financial resilience is driven by reliable operating cash flow, a strong liquidity and balance sheet position, and a diversified mix of low-cost and flexible funding, underpinning a sector-leading dividend policy. Following the significant investments of the last few years in ERFs, we are now poised to reap the benefits as the next four plants come on stream. We have also ensured we are well prepared both operationally and in terms of cost effectiveness for PR19. In recycling, we are optimistic that positive changes will be announced in the Government's Resources & Waste Strategy to be published later in 2018.

We collaborate closely with our customers and have enhanced the way we engage with our workforce. We believe our strong organisational culture will give us a competitive advantage, deliver a high level of service to our customers and ultimately lead to outstanding business performance. Looking ahead, we have many successes upon which we can build as we apply our vision of Bringing resources to life. I am confident the Board, working together with the Pennon Executive and our people, will continue to ensure we are not just a successful company, but a responsible and trusted one too.

Sir John Parker

Chairman

Board diversity

2	4
Women	Men

Q Extreme weather March 2018

In March 2018, a period of abnormally cold weather and snowfall provided significant operational challenges, especially in the South West of England, where the Met Office issued its first ever 'red' warning relating to snowfall in England. The cold weather and rapid thaw led to an increase in burst pipes, resulting in supply interruptions in some areas of Devon and Cornwall. Contingency plans were utilised to ensure supplies of raw water were maintained to water treatment works and leaks resulting in interruptions to supply were fixed as quickly as possible.

South West Water acted swiftly to ensure bottled water supplies were provided to customers without potable water, mobilising South West Water staff (both field and office based), partners and contractors as well as others such as Viridor HGV drivers.

Following the resumption of supplies, South West Water also provided collection points to ensure that the plastic bottles provided to customers could be returned for recycling.

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.

UK water sector

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 32 privately-owned regional companies, of which 10 are providers of both water and wastewater services (source: Ofwat.gov.uk).

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

UK water industry (2017)

10
Water and waste
companies

32
operators
in the UK

22
Water only
companies

How we've responded

South West Water is focused on demonstrating leadership within the water sector, pioneering new technologies and methods to improve customer service, efficiency and resilience while working closely with industry peers and the supply chain to identify and implement best working practice across all areas of the business.

Water regulators

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 2015-2020 plan was awarded enhanced status as part of the 2014 Price Review. The company is currently preparing its submission as part of the 2019 (2020-2025) Price Review.

The Environment Agency is the principal environmental regulator.

The Drinking Water Inspectorate (DWI) is the drinking water quality regulator.

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

UK water regulators

South West Water engages with its regulators at all levels and is committed to ensuring trust and transparency within these relationships.

Non-household retail market

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 Market Operator Services Limited. It has required the separation of the wholesale and retail arms of water businesses.

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

Market choice

1.2m
businesses and other
non-household customers
can choose who they buy
water and wastewater retail
services from

Pennon Water Services has focused on offering high-quality retail customer service and a broad range of services that enhance value. As a result, Pennon Water Services is one of only four retailers who were previously part of a water company to have achieved net growth and has achieved 96% customer satisfaction with the service provided.

Waste inputs to ERFs

We estimate that in the UK, 26 million tonnes of waste were suitable for combustion in ERFs in 2017, 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 11 million tonnes of this waste in 2017. Our facilities processed 2 million tonnes in 2017, giving us a market share of around 20%, based on input tonnages, making the company the joint leader in the sector.

In 2017, the total power generated by ERFs in the UK was 6.2TWh – approximately 1.7% of total UK generation in 2017 and an increase of 19% on 2016.

UK combustible waste (2017)

11m tn
Commercial and industrial waste

26m
tonnes

15m tn
Municipal household waste

Viridor's programme of investment in ERFs continues as planned with 12 facilities due to be operational by 2020/21.

Recycled waste materials

The recycling market has had a challenging year with input quality suffering from local authority cost savings and increasing quality demands on outputs. In 2017, China announced it was prohibiting certain types of waste imports, including plastics and unsorted paper. We are working with new customers to access recycling markets in Asia, which partially mitigate the impact of China's restrictions.

We are optimistic that positive changes will be announced in the Government's Resources & Waste Strategy later this year.

Viridor is a market leader in processing comingled waste streams (where recyclables are mixed in the same bin). In 2017, we processed c.0.7 million tonnes of comingled mixed recyclable waste out of an estimated 4 million tonnes (based on the most recent numbers available), indicating an 18% market share.

The volume of waste for recycling is expected to increase reflecting population growth and a growing public pressure particularly around plastics. As a result manufacturers are taking an interest in securing longer-term supplies of high-quality recycle.

Comingled recyclable waste materials processed in the UK (2017)

4m
tonnes

Viridor had implemented self-help measures before the new Chinese restrictions were introduced. Increased quality sampling regimes ensure recycle is being sent to the appropriate markets. 65% of contracted recycling volumes has been renegotiated to provide sustainable pain/gain sharing mechanisms in the current climate.

Waste to landfill

Households in England generated 22.3 million tonnes of waste in 2017, amounting to 406kg of waste per person. Of this, the UK mainland disposed of 11 million tonnes of active waste (household black bag waste and similar unrecyclable waste from industrial and commercial sources) into landfills in 2017 compared with 12.5 million tonnes in 2016.

In 2017 our landfill sites received 1.5 million tonnes of active waste (14% UK market share). In addition, we received 0.6 million tonnes of inert inactive waste for daily cover and restoration purposes.

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

Tonnes of waste to landfill

12.5m

tonnes of waste to landfill in 2016



11.0m

tonnes of waste to landfill in 2017

Viridor continues to maximise gas yields from its landfills and maximise its external grid connections. It continues to reopen mothballed sites as demand justifies and will maintain well-located sites in areas of landfill scarcity.

Business model

Through our business model, we fulfil our objective 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.

Bringing resources to life

Trusted

We do the right thing for our customers and stakeholders

Collaborative

We forge strong relationships, working together to make a positive impact

What we do...

Our core businesses

Waste management

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

 [READ MORE ON PAGE 28](#)

Water and wastewater

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

 [READ MORE ON PAGE 34](#)

Water retail services

We provide water retail services covering all business customers' water management needs.

 [READ MORE ON PAGE 41](#)

...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 retention, training and development, productivity and, above all, an unwavering commitment to health, safety and wellbeing.

Effective governance

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

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.

Efficient financing

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

Environmental stewardship

We invest in the maintenance and improvement of our services, operations and assets and constantly seek more sustainable ways of working to protect, enhance and reduce our impact on the natural environment.

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.

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.

Responsible

We keep our promises to our customers, communities and each other

Progressive

We are always looking for new ways to improve and make life better

...delivering our strategy

Our 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 ON PAGE 20](#)

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 ON PAGE 21](#)

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 ON PAGE 21](#)

...to create value

Value created for our stakeholders

Customers

85

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

Community

98%

140 bathing waters out of 143 classified as 'sufficient' or better⁽³⁾

Investors

+8.3%

Earnings per share increased to 50.9p⁽²⁾

Environment

1.4m

Tonnes of waste materials recycled

People

14,379

Formal training days recorded for employees

(1) As measured by the service incentive mechanism (SIM). See page 36 for details.

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

(3) 107 beaches (75%) classified as 'excellent'.

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 drivers.

Long-term priorities



Leadership in UK water and waste

Near-term objectives

- Build on the strong track record of our water business by delivering and outperforming the K6 (2015-2020) plan
- Continue to develop a new model for proactive customer service that puts our customers at the heart of everything we do
- Develop and fully maximise value from our infrastructure business
- Mitigate the risk arising from local authority austerity and global challenges in recycling
- Improve our environmental performance
- Strengthen employee engagement across the Group.

Progress in 2017/18

- Outperformance by South West Water continued in 2017/18
- Largest ever programme of customer research and engagement carried out in support of PR19 business planning
- Introduction of customer service improvements have allowed South West Water to increase the speed and quality of its responses through a more proactive, tailored approach
- High levels of performance and availability maintained by the ERF fleet, which delivered £123.7 million EBITDA in 2017/18
- Greater Manchester contract reset – positive outcome reached
- New trading relationships developed within Asia and ongoing 'self-help' initiatives to mitigate challenges in the market
- Reduction in wastewater pollution incidents
- New people strategy developed and Group vision and values launched.



Leadership in cost base efficiency

- Realise value from the organisation change programme following our Shared Services Review
- Continue to maximise the benefits of the integration of Bournemouth Water operations into South West Water
- Ongoing initiatives to reduce central overheads, share best practice and deliver synergies.

- £13 million of Group-wide efficiencies secured to date, including integration of a Group-wide IT platform. On track to deliver £17 million by 2019
- Final phase of Bournemouth Water integration complete: on track to deliver K6 cost savings of £27 million
- South West Water cumulative totex efficiency of £177 million driven by continuing advantages from our strategic alliances
- Cost-efficient, long-term financing in place – 3.7% interest rate on annual net debt.



Driving sustainable growth

- Continue to grow the ERF business, including the successful completion of construction projects at Glasgow, South London, Dunbar and Avonmouth ERFs
- Build on the success of PR14 by developing a high-quality, ambitious and innovative business plan for PR19 that meets the needs and priorities of South West Water's customers and other stakeholders
- Continue to build scale and efficiency in the non-household retail market through Pennon's water retail business, Pennon Water Services
- Identify and consider opportunities for further growth, including initiatives to expand our customer base or form partnerships with other organisations.

- £398 million invested in key infrastructure during the year
- Perpetual capital securities issuance delivering funding and balance sheet flexibility
- Three ERFs in commissioning and one under construction
- Well positioned for regulatory and market developments – ongoing engagement with Ofwat reforms and prepared for the 2019 price review
- Construction of the innovative Mayflower water treatment works in Plymouth – on track to become operational in 2018
- Progress towards the adoption of water and wastewater services for the Isles of Scilly in 2019
- Pennon Water Services' high-quality, service-based approach means it is one of only four retailers who were previously part of a water company to achieve growth since the competitive market opened in April 2017, with the second lowest attrition rate
- Sustainable dividend – increase in total dividend for the year of 7.3% reflecting strong performance of Pennon's water and waste management businesses.

KPIs

92%

average ERF
availability⁽¹⁾

91%

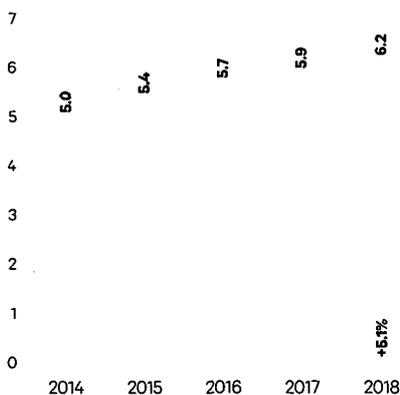
customer
satisfaction with
overall service⁽²⁾

- (1) Weighted by capacity, excludes Bolton, includes JVs at 100%.
(2) South West Water score for 2017/18. The customer satisfaction score for Bournemouth Water was 96%.

£259m

increased underlying PBT
including the benefit of cost
efficiencies across the Group

Group assets as at 31 March (£bn)



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 while 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 while 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.

**We are building an
asset business and
a people business**

GROUP PERFORMANCE

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Review of the Chief Executive Officer

Chris Loughlin
Chief Executive Officer

“Customer needs and priorities will continue to be the cornerstone of our operations.”

I am pleased to report the Group made excellent progress against our strategic objectives, implementing changes to deliver Group-wide synergies and savings within our water and waste businesses while delivering on our promises to customers, maintaining a responsible approach to finance and creating business growth across the value chain. We believe all companies should be held to the highest possible standards and welcome the dialogue between the Government, our regulators and the wider water industry. As the Chairman has stated, South West Water already operates in line with Ofwat's proposed improvements.

Health and safety

As I said last year, we are committed at the highest level to showing leadership in improving safety by using concepts and learnings from a range of industries, including high-hazard sectors. This remains our ambition. I am pleased to note the progress we have made following the creation of our new health and safety programme HomeSafe. As detailed in the Chairman's statement (page 08) and the Our People section (page 26) of this Report, this wide-ranging behavioural change programme is being adopted by everybody working at Penon and is creating a clear and structured long-term platform for all health and safety activity.

Building our leadership in water and waste

Our water business continued to outperform during the year, despite adverse extreme winter weather. Strong operational and financial performance underpinned our sector-leading return on regulated equity, which consistently tracks above 11%. While we incurred a penalty for pollution incidents, South West Water achieved overall outperformance against its outcome delivery incentives (ODIs), resulting in a net reward of £2.6 million for the year. We are committed to reducing the number of pollution incidents and a programme of actions is underway, which has already shown good progress (see pages 38 and 40 for further details).

We continue to share the benefits of our outperformance with our water customers through our unique WaterShare mechanism. Since 2015, we have identified £79 million to be shared with customers. Our focus on cost efficiency means South West Water's average annual bill is lower than it was nine years ago and this underlines the Group's strong commitment to delivering the best possible service to customers.

Our continuing investment in our assets and distribution network has allowed us to deliver notable improvements in drinking water and bathing water quality, while our leakage levels have almost halved since privatisation. At the same time, we continue to maintain conservative gearing levels, ensuring the amount of debt we take on is consistent with Ofwat's notional view of an efficient company.

In September 2018 South West Water will submit its combined business plan for the 2020-2025 regulatory period (PR19), covering both the South West and Bournemouth operating areas. Ofwat's final methodology for PR19 was published in December 2017 and indicates a relatively more prescriptive approach than PR14, with an even greater focus on cost efficiencies and the delivery of exceptional service to customers; South West Water

is well placed to meet these challenges. As part of our preparations for PR19 – which have included our largest programme of customer research and engagement to date – we launched the ‘Get into Water’ campaign which has been helping us to further understand customer needs and preferences.

We believe c.£6 to £9 billion of investment will be required over the 30 years to 2050. The anticipated areas of investment are: resilience, environmental protection and enhancement, security of supply, flood protection and transformational improvements to customer service.

Our waste operations again performed well with the fundamentals of the UK waste market remaining strong and demand for energy recovery facilities (ERFs) set to continue to exceed capacity. We anticipate the capacity gap to be greater than seven million tonnes by 2030. The ERFs performed strongly and the operational part of our portfolio has achieved an availability of 92%⁽¹⁾.

Elsewhere in our waste operations, Viridor successfully negotiated a reset to its contract with the Greater Manchester Waste Disposal Authority, achieving a positive outcome.

In recycling, we are seeking to influence government policy, including to mitigate increasing pressure on input quality from local authority cost savings. We have invested to ensure output quality requirements are delivered and are seeking further targeted investment in value adding technology. Our risk/reward share with customers now covers 65% of input volumes.

We are maintaining flexibility in our landfill operations, where we continue to see demand for landfill solutions.

Investing for sustainable growth

Development of our ERF portfolio continued during the year with three plants progressing through commissioning, and construction of our 12th facility at Avonmouth near Bristol on track for delivery in 2020/21. The majority of Viridor's capital investment continues to relate to the delivery of the ERF portfolio, which will support Pennon's earnings growth to 2020 and beyond. We have successfully implemented all phases of our ERF business model from initial concept to raising investment, gaining planning permission, building facilities, winning contracts and operating plants to high levels of efficiency.

While a small part of the Pennon Group, our subsidiary Pennon Water Services, which provides retail services to non-household customers across the UK, is now serving over 160,000 retail customer accounts across 18 different wholesale regions. The business achieved net growth in customer accounts during the year with some c.7,000 accounts switching to Pennon Water Services (see page 41 for more information). Pennon Water Services is ringfenced from South West Water and can secure services from any wholesaler in the UK.

Cost efficiency drive continues

South West Water maintained its strong track record in controlling total expenditure (totex) with cumulative savings of £177 million and financing outperformance of £100 million in the first three years of K6 (2015-2020).

Q Looking to the future: what do our customers think?

In preparation for PR19 we have been carrying out research and engaging with our customers and stakeholders across the South West and Bournemouth areas to refresh our understanding of their long-term priorities. In September 2017, we captured the results of that process in WaterFuture 2050. It sets out our updated long-term vision (2020-2050) and also highlights some of the specific service levels we are proposing to achieve between 2020 and 2025. To ensure that the views of our customers and stakeholders remain central to our plans, we invited further feedback on the priorities and proposals for the 2020-2025 period. New interactive tools and techniques for greater customer participation include our Get into Water campaign that is built around a video showing how South West Water is planning for the future. We invited the public to have their say via our social media channels including YouTube, Twitter, Facebook and LinkedIn. This campaign generated thousands of customer interactions.

£177m

cumulative totex
outperformance

92%

average
ERF availability⁽¹⁾

 **READ MORE ONLINE**
www.southwestwater.co.uk/waterfuture

(1) Weighted by capacity, excludes Bolton, includes JVs at 100%.

Review of the Chief Executive Officer

continued

Pennon continues to drive greater synergies and savings across the Group and share best practice through the Shared Services programme. Both Viridor and South West Water have a breadth and depth of experience in managing large asset bases and in using innovative engineering and technology to increase efficiency and effectiveness. We are sharing this knowledge across the Group so we can harness our combined skills. We are on track to achieve by 2019 the annual cost savings and synergy targets of c.£17 million which were initially identified in the 2016/17 Shared Services Review.

Pennon continues to drive greater synergies and savings across the Group.

In the water business, the integration of Bournemouth Water's business into South West Water operations has provided a natural opportunity for consolidation. Our target is for c.£27 million of cumulative synergies by 2020 and we are on track to achieve this.

In our waste operations, we centralised control to optimise performance across the UK. We have focused on driving efficiencies by entering into more framework contracts in partnership with key suppliers and by rationalising our supplier base. We continue to implement self-help measures in our recycling business by rationalising facilities, renegotiating contracts and sharing commodity risk and reward with our clients.

Enhancing sustainability and resilience

In fulfilling their role of serving local communities, stewarding resources and providing essential services, our water and waste businesses integrate long-term sustainability into their strategic thinking.

South West Water's role is to secure adequate supplies of water, treat it to high drinking water standards, provide resilience to prevent flooding or droughts and to return water to the environment in a responsible and benign way. This is essential for the long-term resilience of our water business. We continue to make good progress in our programme of catchment management initiatives working with local landowners and farmers in a wide range of upstream and downstream initiatives.

UK waste strategies prioritise waste minimisation and recycling wherever possible, followed by energy recovery for non-recyclable materials, with landfill always the last resort. Viridor's strategy aligns with that. When Avonmouth ERF is operational the Group will hold some 19% of national energy recovery capacity and we will be the UK leader in this sector.

Our gross carbon emissions increased by 11% as our fleet of operational ERFs continues to grow while we scale down our landfill operations (in themselves the most significant contributors of greenhouse gas). Our full greenhouse gas (GHG) reporting can be found on pages 102 and 103. We continue to work to minimise and reduce the carbon intensity of our operations and to maximise the carbon benefits of our services for customers.

Pennon is both an asset business and a people business. The Group can only be as good as the people who build and operate its assets. Training, developing and retaining employees who have the right skills to take us forward is an essential part of our strategy. This year for the first time, we ran a Group-wide employee engagement survey that is helping us identify what matters to our employees so we can deliver improvements that benefit and strengthen their skills and our culture as well as our operations.

Reducing our environmental impacts remains a priority. We are an active member of Business in the Community, and were delighted to retain our 3 star rating in their Corporate Responsibility Index and improve our score

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 that help to address the environmental challenge of depleting natural resources.

to 92% this year. We also collaborate on initiatives including their Circular Economy Task Force. We also retained our inclusion in the FTSE4Good Index, following independent assessment in 2017 of our environmental, social and governance (ESG) performance.

Our people

We look to attract, develop and retain a highly skilled and customer-focused workforce, supported by our award-winning apprenticeship programme (see Our people on pages 26 and 27 for more information).

Our employees supported communities through 225 days of volunteering during the year with Viridor exceeding the goal that it had set of delivering 1,500 hours of volunteering by 2018. Both South West Water and Viridor continue to offer broad community education programmes.

Our success relies on the professionalism and hard work of our employees and I would like to thank all of them for their dedication during the year.

Key performance indicators (KPIs)

We have made some changes to the KPIs we present in the annual report, to ensure they are consistent with those adopted as part of our revised remuneration policy, approved by shareholders last year. The KPIs set out on pages 24 and 25 are those used by the Board to measure the performance of the business in delivering the strategy and are directly relevant to executive remuneration. Additional metrics are provided within the operational and financial reviews (pages 28 to 51).

Outlook

Customer needs and priorities will continue to be the cornerstone of our operations. In our water business, we will continue to share with customers the rewards we receive for outperformance while working to maintain high standards of customer service. In our waste operations, we will work with local authorities in a strong spirit of partnership.

In water, the successful merger of Bournemouth Water into South West Water has strengthened our operations. We are also currently in talks regarding extending our operational area to cover the Isles of Scilly. In waste, growth will come from our ERF portfolio, with the expansion supporting earnings growth to 2020 and beyond, as additional facilities come on stream. We expect demand in the wider residual waste market to exceed capacity over the long term.

South West Water continues to lead the sector in many areas, delivering RoRE outperformance through totex savings, financing with the lowest effective rates in the industry and achieving net ODI rewards. We are determined to sustain our outperformance momentum over the remaining K6 regulatory period, remain at the forefront of cost efficiency for the water sector and continue to share these benefits with our customers. This is a strong platform as we prepare for PR19 and develop our business plan for the next regulatory period 2020-2025. We are demonstrating a real commitment to engaging our customers and other stakeholders in this regard. While we expect PR19 to be challenging, South West Water is well placed to respond and to continue delivering truly outstanding services to customers.

Q New systems delivering great results

Working closer together over the past 12 months has helped us achieve some great things for our customers, employees and our business.

More than 250 people from across the Group have been involved in project Enterprise, which is helping us to work smarter. Enterprise has delivered new standardised systems and processes for Viridor leading to more consistent and better quality data, and making life easier for our people, the business, our suppliers and customers.

Making the most of our size and scale, Pennon is also launching a Group-wide travel management system helping our employees save time and effort when booking business travel, and helping the Group make significant savings.

To support and deliver ongoing improvements across Pennon, a Senior Leadership Forum has been established, bringing together leaders from across the Group to collaborate and keep aligned on the progress we are making against our strategy.

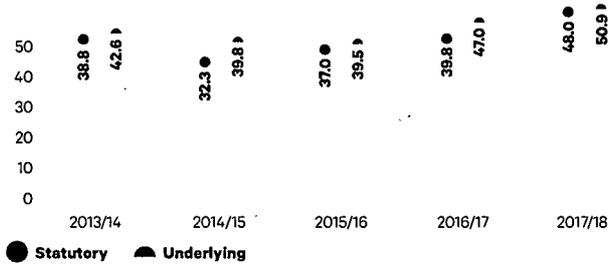
I believe Pennon Group is well positioned to deliver for its customers, communities and shareholders through a clearly articulated strategy for water and waste operations in the UK, while taking a progressive approach to working with policy makers to achieve change within the water sector.

Chris Loughlin
Chief Executive Officer

Key performance indicators

Long-term

Earnings per share (pence)



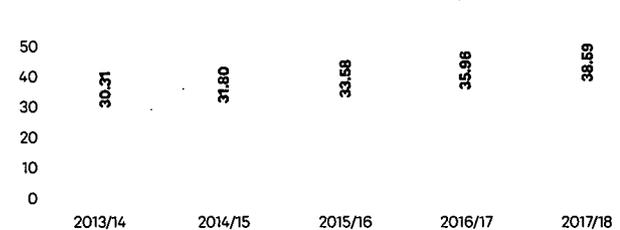
Relevance to remuneration
LTIP (40%)

Alignment to strategy

1, 2, 3

For more information and discussion of our performance during the year see the Report of the Chief Financial Officer, pages 42 to 51.

Dividend per share (pence)



Relevance to remuneration
LTIP (40%)

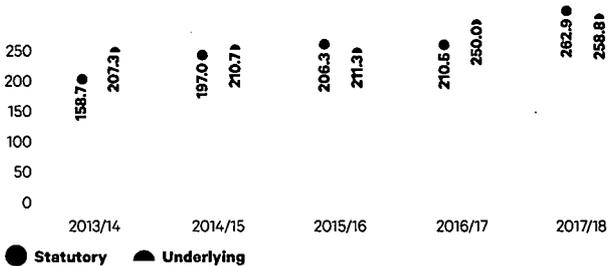
Alignment to strategy

1, 2, 3

For more information and discussion of our performance during the year see the Report of the Chief Financial Officer, pages 42 to 51.

Annual Operational

Profit before tax (£m)



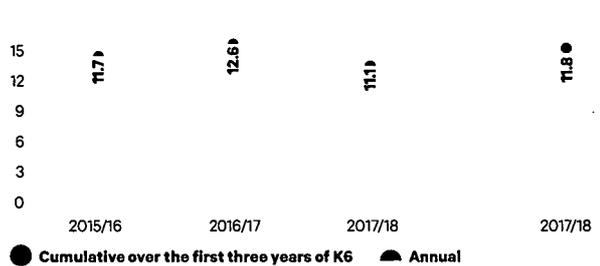
Relevance to remuneration
Annual bonus (50%)

Alignment to strategy

1, 2, 3

For more information and discussion of our performance during the year see the Report of the Chief Financial Officer, pages 42 to 51.

Return on regulated equity (RoRE) (%)



Relevance to remuneration
Annual bonus (10%)

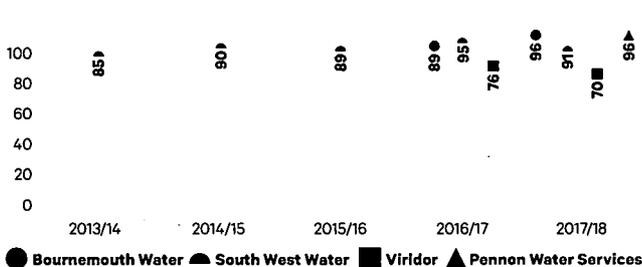
Alignment to strategy

1, 2, 3

For more information and discussion of our performance during the year see Our operations, Water and wastewater, page 36 and the Report of the Chief Financial Officer, page 42.

Sustainable business

Customer satisfaction with overall service (%)



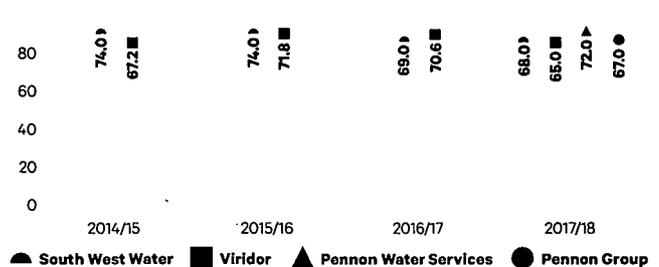
Relevance to remuneration
Associated with annual bonus operational or personal metrics⁽³⁾

Alignment to strategy

1, 3

For more information and discussion of our performance during the year see Our operations, pages 30, 36 and 41.

Employee engagement (%)⁽³⁾



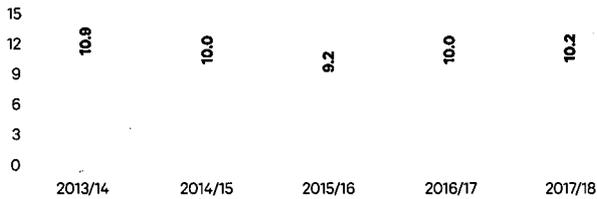
Relevance to remuneration
Associated with annual bonus operational or personal metrics⁽³⁾

Alignment to strategy

1, 3

For more information and discussion of our Group-wide employee survey see Our people, page 26.

Return on capital employed (RoCE) (%)



Relevance to remuneration
LTIP (20%)

New metric introduced for the LTIP in 2017.
See page 92.

Alignment to strategy

2,3

Our strategic priorities

1

**Leadership in UK
water and waste**

2

**Leadership in cost
base efficiency**

3

**Driving sustainable
growth**

Our KPIs are aligned to our three strategic priorities. For more information on our strategic priorities see pages 16 and 17.

- (1) Comprising different elements for the CEO, CFO and members of the Pennon Executive.
- (2) Average availability for the year for the five ERFs constructed by Viridor plus our two joint ventures weighted by capacity (JVs at 100%) and excludes Bolton.
- (3) In 2017/18 we introduced a Group-wide employee survey, which changed the methodology for calculating employee engagement. See page 26 for more information.
- (4) Incidents involving employees under the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations.
- (5) Tonnes of carbon dioxide equivalent.

ODI net rewards (£m)



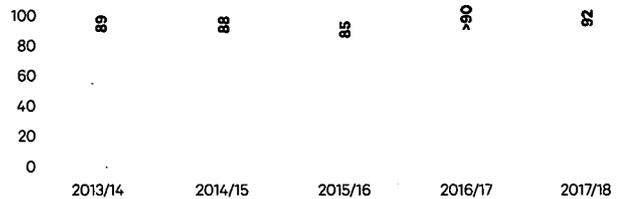
Relevance to remuneration
Associated with annual bonus operational or personal metrics⁽⁹⁾

For more information and discussion of our performance during the year see Our operations, Water and wastewater, page 36.

Alignment to strategy

1,3

ERF availability (%)⁽²⁾



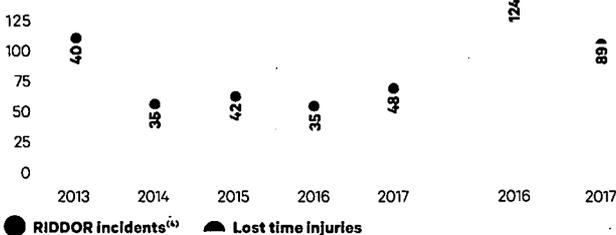
Relevance to remuneration
Associated with annual bonus operational or personal metrics⁽⁹⁾

For more information and discussion of our performance during the year see Our operations, Waste management, pages 30 and 31.

Alignment to strategy

1,3

Health and safety



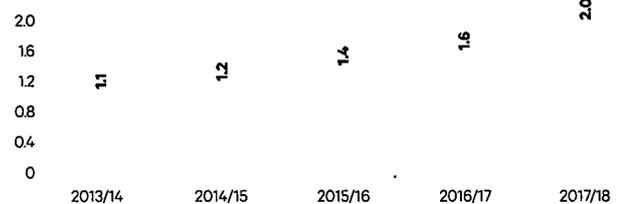
Relevance to remuneration
Associated with annual bonus operational or personal metrics⁽⁹⁾

For more information and discussion of our approach to health and safety during the year see the Chairman's statement, page 08, the Review of the Chief Executive Officer, page 20 and Our people, page 26.

Alignment to strategy

1,3

Carbon emissions (million tCO₂e)⁽⁵⁾



Relevance to remuneration
Associated with annual bonus operational or personal metrics⁽⁹⁾

For more information and discussion of our performance during the year see the Review of the Chief Executive Officer, page 22, and the Directors' Report, page 102.

Alignment to strategy

1,3

Our people

We strengthened Group-wide engagement through our new people strategy and a common vision – Bringing resources to life – while carrying out our first ever Group-wide engagement survey and introducing HomeSafe.

People strategy

Group-wide management of our new people strategy 'talented people doing great things for our customers and each other' is led by our Group director of HR. The six threads: leadership; culture; people processes; compliance; training; and talent are helping us to focus more than ever on being a place where people enjoy working.

As part of our commitment to improve two-way communications with our workforce, we asked our people across the Group what they feel makes us unique as a business and what motivates them. We complemented this with sessions with the Group's leadership, our employee survey data and external benchmarking. The results showed we had much in common across the Group in terms of what we value and a shared sense of purpose in the work we do. This insight allowed us to develop a new vision: Bringing resources to life, with its associated values of 'trusted, responsible, collaborative and progressive'. Work to embed our new vision and engage employees, customers and shareholders is underway.

Workforce engagement

Involving our staff in the decisions we make helps us deliver the right business solutions. A company can only be as good as its people so our Group HR team is finding new ways to enhance Pennon employees' voice so that our people feel empowered.

A landmark was our first Group-wide employee survey. We were pleased to see a high response rate of 75% with a Trust Index® score of 60% and an Engagement Score of 67%. Our Trust Index® is above the UK national average, but slightly below the 70% threshold for being considered a 'Best Workplace'. The survey identified clear Group strengths in communication and involvement, trust, diversity, and empowerment and accountability. It also revealed areas requiring further work. These include continuing to ensure our people understand the Group's strategy and direction, as well as maintaining our focus on embedding our values into everything we do, while recognising the contribution made by our employees. Our Group-wide turnover rate in 2017/18 was 15.86%.

Other initiatives include our quarterly Senior Leadership Forum which brings together leaders from across the Group to ensure they are engaged in our strategy and 'The Big Chat', which gives employees the chance to put questions to the Pennon Executive. We also introduced our six-monthly Employee Voice Forum at Viridor to complement the

Q HomeSafe

As its name implies, HomeSafe is about ensuring staff get to work safely, enjoy a safe and healthy working environment, and arrive home without incident at the end of each working day. It was created in consultation with employees to ensure real needs are addressed by the programme content. In August 2017, we held a Stand-Up for HomeSafe event involving over 4,000 employees to formally launch the concept right across the Group. A three-week pilot programme at Viridor's materials recycling facility in Plymouth, in December 2017, further refined the concept and safety behavioural tools. A series of interactive and highly visual learning events taught staff about key standards, processes and expectations in H&S, including guidance on understanding workplace hazards, identifying opportunities for improvement and how to apply appropriate safety rules. Daily training sessions allowed content, teaching materials and tools to be streamlined. Informal evaluations after the pilot showed staff warmly welcomed the HomeSafe approach. HomeSafe is now being deployed across Pennon, involving 6,500 staff and agency workers.

well-established staff council at South West Water. An open, transparent and safe working environment, where workers feel able to speak up and are supported if they do so, is encouraged by Speak Up, our whistleblowing policy.

Health and safety (H&S)

As well as launching HomeSafe across the Group in 2017, we continued to look to strengthen other areas of our H&S approach. New training for supervisory staff, language lessons for our non-English speaking workers and safety behavioural training for our front line employees all featured. We also created a broader set of H&S indicators to improve management information and insights, and safety performance. In addition to recording RIDDOR injuries and ill health cases, we now also record lost time injuries*. This broader data set allows for a better understanding of injury causes and allows us to benchmark against other companies across many sectors. We recorded 89 lost time injuries in 2017, a 28.2% reduction compared with 2016. For 2018, we will review the current safety performance measures to ensure they remain the most appropriate.

* A lost time injury is defined as any work related injury that results in a person being unfit for work on any day beyond the day of the incident.

As at 31 March 2018, 14,379 formal training days had been recorded for employees across Pennon.

Further enhancements to the way we record and report H&S events include introducing a new Incident Management System and associated standards and processes to provide better, more accessible, real-time data, allowing further insights and actions to aid learning and prevention.

Employee training and development

We remain committed to investing in the development of our staff; we want to recognise talent across the Group. We support employees at all levels through training and development, helping to increase productivity, job satisfaction and safety, as well as developing our next generation of leaders by encouraging people to develop their knowledge, skills and competencies.

The Government's apprenticeship reforms and introduction of the apprenticeship levy are helping us prioritise development for new and existing employees to address key skills shortages. Pennon plays an active role in developing skills and raising training standards across the water and waste industry through our membership of the Energy and Utility Skills Council and we have partnered with award-winning vocational training provider System Group to develop employees in engineering, driver training, project management and team leadership.

Code of Conduct

In June 2017, we introduced the new Pennon Code of Conduct. To ensure everybody has the same understanding of what the new Code means, all employees were required to complete an e-learning module. This was followed by ancillary training on anti-bribery and anti-corruption, and the acceptance of gifts and hospitality, to ensure we have strong compliance across the Group. Training on the Code and our legal compliance policies is compulsory for all our workers. Further information is provided on page 72.

South West Water

Many front-line operational roles are regulated and supported by high-quality training standards. Training is accredited and reviewed periodically to ensure high standards are maintained. We keep a register of personal training and skills and individuals receive a photo ID card displaying the training and skills programmes completed and associated expiry dates.

Viridor

Viridor's workforce represents more than 40 different nationalities, with a high percentage of Polish workers, and, in April 2017, we partnered with RWS Language Solutions (RWS) to provide interpretation and translation services. This partnership enables key documents such as site operating procedures and health and safety policies to be translated into native languages. RWS also provides interpreters, where necessary, to ensure workers understand what is expected of them and can work in as safe a manner as possible.

Diversity and equal opportunities

The Board continues to promote equality of opportunity and diversity across the Group in all areas, including gender and ethnicity. This remains a key area of focus – see both the Nomination Committee report page 81 and the Directors' Report page 102 for further details. In line with all organisations with 250 or more employees, we published details of our gender pay gap for the first time. As a Group we have a mean average pay gap of 5.5% with South West Water at 4.0% and Viridor at 6.9%. These figures are more favourable than the national average.

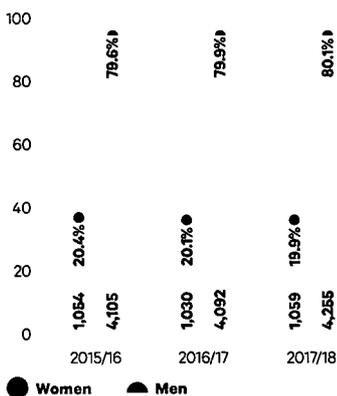
Gender diversity

Across Pennon Group, the workforce comprises 80% male and 20% female employees. This gender split reflects the traditional male-dominated industry. In our water business, 27% of the employees are female, which is consistent with previous years. In Viridor, 85% of the employees are male. Across the Group, 23% of the senior managers are female which again remains consistent with the previous year.

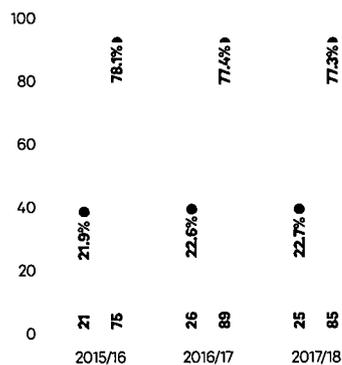
Addressing diversity has been a priority for us and we believe we should do more to access the wealth of diverse talent in the marketplace. We have developed a six point plan to help make Pennon a more diverse place to work (read more at www.pennon-group.co.uk/gender-pay-gap).

Gender diversity as at 31 March

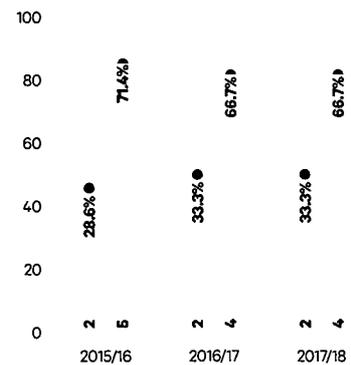
Employees



Senior management



Board



Our operations

Waste management

Powering homes and businesses
Energy is converted into electricity and provided directly to the grid.

Energy recovery facilities (ERFs)
Residual household and business waste is transformed into a usable form of energy.

We remain at the forefront of the UK resource sector, transforming waste into energy, high quality recyclates and raw materials.

 **READ MORE ONLINE**
www.viridor.co.uk

“ Viridor has delivered a strong financial and operational performance, led by increased availability across the ERF portfolio. We continue to work closely with our customers to deliver quality service and value for money. We are navigating challenges in recycling markets and are well positioned to deliver improved results as markets stabilise. ”

Phil Piddington
Managing Director, Viridor

A fleet of waste collection vehicles
Waste collected directly from businesses and safely transported to our facilities.

Trading recycled materials
Selling recycled materials around the world.



Landfill sites and power generation

Safe disposal of waste that cannot be recycled or sent to ERFs.



Materials recycling facilities (MRFs)

Separating and preparing recyclable materials for manufacturing into new recycled products.

100km

● Materials recycling facility ○ Energy recovery facility

Key facts

8

energy recovery facilities in operation, three in commissioning and one more in construction

400,000

potential homes powered by energy produced by our portfolio

150

local authority and major corporate clients

32,000

customers across the UK

300+

recycling, energy recovery and waste management facilities

600

waste collection vehicles securing materials for our network of assets

7.0

million tonnes of waste materials input

1.4

million tonnes of recyclate traded

Household waste recycling centres (HWRCs)

Public disposal sites for the collection of recyclable and non-recyclable household waste.

Our operations

Waste management continued

Viridor is at the forefront of the resource sector in the UK, transforming waste into energy, high-quality recyclates and raw materials. We provide services to more than 150 local authorities and major corporate clients as well as more than 32,000 customers across the UK. Our activity supports the development of a regenerative circular economy that seeks to keep resources in use for as long as possible and recover and regenerate materials at the end of their service life.

Our operational ERFs are delivering above initial base case expectations.

Viridor maintains strong performance

Viridor continued to develop a fully integrated service of waste management, recycling and recovery during the year. Highlights of our performance include the continuing success of our ERF portfolio. With three of our ERFs under construction progressing through commissioning, we have successfully implemented all phases of our ERF business model from initial concept through to completion, and our operational ERFs are delivering above initial base case expectations. We negotiated a reset to the contract with the Greater Manchester Waste Disposal Authority (GMWDA), which had a positive outcome. Global recycling markets have been challenging, in particular following changes in China's import regulations. We have partially mitigated the impact of these challenges through self-help measures, including finding new export markets. We are investing in quality improvement processes in our recycling facilities as the quality of input materials has deteriorated while demands on the quality of outputs have increased. In landfill, the rate of volume decline has slowed during the year and we are adopting a flexible strategy.

Total waste inputs for 2017/18 were 7.0 million tonnes, with 2.2 million taken by our ERFs, 1.5 million going to landfill and 3.3 million taken by our recycling and other facilities.

Viridor is one of the UK's largest independent power generators from waste. We had 274 megawatts (MW)⁽¹⁾ of operating capacity from ERFs, anaerobic digestion,

solar and landfill gas (including 100% of joint ventures) at 31 March 2018. Viridor exported 1.5 terawatt hours of power during the year.

Customer experience

Responding to feedback from our customer service surveys for a more seamless service, we have been working to improve integration across our marketing and sales, service delivery and customer service teams.

The resulting reorganisation has created a platform for launching national initiatives based on great customer service, excellent service delivery and transparent pricing.

We rolled out a number of initiatives during the year to benefit our customers, including training programmes for all heads of sales teams and customer service staff, developed a more customer-centric website and organised a number of meet the customer days and events giving customers the opportunity to see our facilities and what happens to their waste.

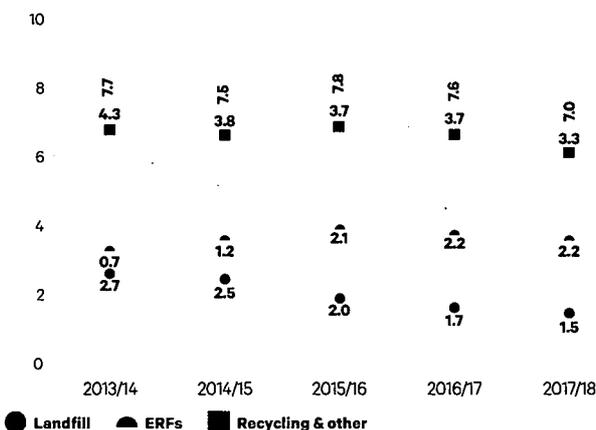
Building on the success of last year's customer survey, a new methodology has now been adopted, which allows us to gather the views of a much broader base of customers. In November 2017 we asked more than 6,000 customers about their perception of Viridor, which provided positive feedback that the reorganisation is delivering benefits to our customers and identified opportunities to improve our performance and drive growth. Of those who responded, 70% were satisfied with our service overall. This will provide the benchmark for future surveys, which will be carried out on a six-monthly basis.

ERFs build momentum

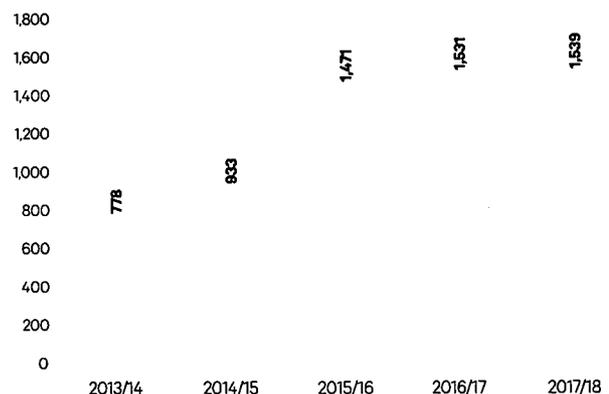
Our ERF portfolio, which turns black bag waste into energy, is a significant asset base which performed strongly during the year. The operational ERFs delivered increased EBITDA in the year. Like for like facilities contributed a 9% increase as a result of our focus on optimisation of the facilities with the remainder reflective of a financial contribution⁽²⁾ from Dunbar ERF. Our operational ERFs are delivering above initial base case expectations and are helping to deliver the Group's growth strategy.

(1) Including Bolton ERF.
(2) Reflecting liquidated damages.

Total waste material inputs (million tonnes)



Total low carbon energy generation (GWh)



At year end, the operational ERFs had a capacity of 2.1 million tonnes of waste and 178MW of electricity p.a. (including 100% of joint ventures). This will extend to 2.9 million tonnes and 242MW in 2018/19 and 3.2 million tonnes and 276MW by 2021.

Our ERF at Beddington in South London is in final commissioning, with waste deliveries being received and financial contribution being recognised from the first half of 2018/19. Work at Dunbar continues to progress, with liquidated damages expected to be received until commissioning is complete. Both Beddington and Dunbar are expected to be completed on budget. Progress at Avonmouth near Bristol is on schedule and budget. Piling for the ERF building has been completed, the bunker construction is well underway and process steelwork is being erected.

At the Glasgow Recycling and Renewable Energy Centre, the materials recycling facility and anaerobic digestion facility have operated throughout the year and commissioning is underway for the advanced combustion facility.

Including the £173 million total remaining capital expenditure for completion of the ERF portfolio, the total investment in ERFs is £1.5 billion.

Environmental impacts

We keep a strong focus on our environmental performance and responsibilities, working closely with environmental regulators (the Environment Agency, Scottish Environment Protection Agency and Natural Resources Wales) to maintain high standards of operations and compliance, and to further reduce the risk of pollution incidents. In addition to the services Viridor offers its customers for the safe management, treatment and disposal of hazardous wastes, our environment policy clearly commits Pennon to minimising hazardous wastes used or produced and any impacts arising, as well as any (non-GHG) emissions to air. This is monitored via our performance, compliance and reporting against our operating environmental permit conditions. Our full GHG reporting can be found on pages 102 and 103.

Q Avonmouth ERF

Construction of the £252 million ERF in Avonmouth, on the outskirts of Bristol, made strong progress during the year. The facility will enable local authorities and businesses to transform 320,000 tonnes of non-recyclable residual waste each year into renewable energy, which would otherwise go to landfill. Once operational in 2020/21, the new ERF will generate an estimated 34MW of low carbon energy, supplying National Grid with enough electricity to power over 70,000 homes. As part of Viridor's commitment to supporting the local economy around its developments, Viridor held Meet the Buyer events in Bristol where 30 local businesses attended, from which several local contracts have been awarded.

Dynamic landfill strategy

Viridor operated 11 landfill sites throughout the year. The rate of volume decline has slowed during the year, and pricing has held up. With the sites of competitors having closed and with insufficient capacity in the UK ERF market, we are operating a dynamic landfill strategy. Sites are being kept open for longer, with the aim of optimising their long-term value, and investment will be made in new cells where there is commercially attractive demand. We are also investing in our landfill gas business to enhance the long-term reliability of our assets.

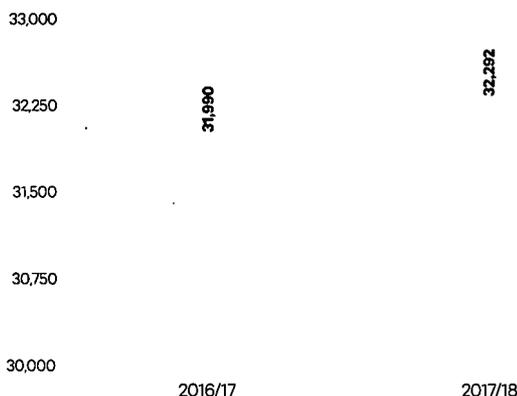
We constructed new cells at four sites in 2017/18. Consented landfill capacity reduced from 42.5 million cubic metres (mcm) to 40.5mcm, reflecting usage during the period.

We continue to manage our landfill energy business with the aim of maximising the value of landfill gas power generation. We are also looking at alternative commercial development opportunities and other energy uses such as photovoltaic and energy storage at our landfill sites.

At year end, our landfill gas sites had engine generation capacity of 88MW, a decrease from last year's 99MW.

During the year, cells at some sites were reopened to landfill, resulting in a short-term reduction in the volumes of gas captured. In addition, higher engine maintenance – as part of an engine replacement programme – resulted

Customer base



Our operations

Waste management continued

in a one-time larger reduction in landfill gas power generation output for the year, down 13% to 445 gigawatt hours (GWh). This level of reduction is not expected to recur. Average revenue per megawatt hour (MWh) was £93.39 (2016/17 £87.16). Average operating costs were £40.96 per MWh (2016/17 £33.02).

Recycling

Viridor retained its position as one of the leading recycling businesses in the UK, although the market environment remains challenging. Recycling volumes traded in 2017/18 were lower than the previous year at 1.4 million tonnes, in part reflecting a decision not to tender certain contracts where the level of contamination in inputs was unacceptable.

We were active across the recycling spectrum, including mixed materials, glass, plastics and paper recycling, as well as 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 more than 230,000 tonnes of glass in 2017/18.

Self-help measures continue

The UK's national policy is to recycle as much as possible and Viridor's operations align with that. However, as local authorities seek to cut costs, the quality of materials brought in to our recycling assets is under pressure. As part of our continuing self-help measures, we are rationalising facilities and investing in quality improvement schemes.

One of the most important developments in the recycling market over the past year was the change in import regulations in China, which has announced new quality requirements for imports of plastic and paper with the expectation that China will take lower volumes of these materials. This does not affect other parts of our recycling operations as the metal and glass that Viridor processes stays in the UK.

Our high-quality recycle helps manufacturers reduce reliance on imported materials.

Viridor anticipated this change in advance of China's announcement and has secured new markets for plastic waste in the UK, Asia and elsewhere in Europe. We are also making additional investments and working with our supply chain to improve the quality of paper recycling for China.

During the year, recycling EBITDA was £15.0 million, a decrease of 33.9% against the previous year's £22.7 million. Around £3.0 million of the reduction related to the pricing and quality implication of China's policy announcement. The remaining reduction of £4.7 million reflects our overall reduction in recycling volumes and an increase in processing and reject costs as a result of lower input in quality, and higher output quality demands. EBITDA per tonne decreased by £3 year on year to £11 as a result of higher processing costs (up £11 per tonne to £83 per tonne) offset by higher pricing. Revenue per tonne was up 7.8% to £97 (2016/17 £90), reflecting a shift towards higher value output including polymers. Compared with the second half of 2017/18, we anticipate market and operational improvements into 2018/19.

Sharing commodity risk and opportunity

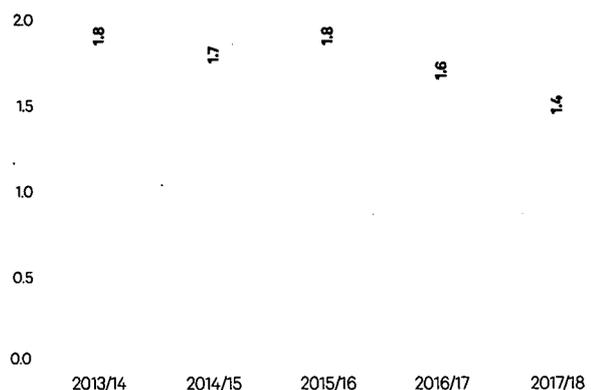
In line with the Group's strategy of achieving a balanced risk profile across its operations, we continue to work with stakeholders to share commodity risk and opportunity. At year end, 65% of our contractual volumes from local authorities had been renegotiated to share recycle commodity risk (up from c.40% last year).

Q Investments in glass recycling to meet customer needs

Viridor has invested in its glass recycling facility at Newhouse near Glasgow to take comingled glass. The site was originally designed to take only single-source separated glass bottles and jars. The latest investments from Viridor meet the quality standards demanded by today's bottle-makers.

Some 60% of feedstock for Newhouse comes from local authorities, with Viridor contracted to serve 17 of Scotland's 32 local authorities. Newhouse uses a range of technologies such as advanced colour-sort recycling that is capable of processing both mixed and colour-segregated glass. The output is sold to bottle-makers, who turn it into new bottles and jars.

Recycling volumes traded (million tonnes)



Q Supporting STEM (science, technology, engineering & maths) projects in schools

Viridor is a leading sponsor of Go4Set across Scotland, a schools educational programme challenging young people to think about their future environment and how we utilise resources.

The programme encourages young people to be the engineers and scientists of tomorrow and helps them develop skills in team working, communication, report writing and problem solving – all essential skills in the working world.

Confidence in UK waste sector, strong drivers for recycling

Viridor, alongside the waste industry, has called for a new attractive framework for UK recycling to address input quality to UK materials recycling facilities, stagnant recycling rates and producer responsibility.

We are encouraged that the 'Blue Planet' effect is spurring action and we are optimistic that positive changes may be announced in the Resources & Waste Strategy later this year creating a UK recycling system fit for the future including incentives for 'producer responsibility', consistency of household bin collections, increasing household waste quality, new packaging recycling targets and packaging recovery note reform, making recycling more profitable and enabling investment and innovation.

Local authority contracts

We continue to work with customers to identify mutually beneficial enhancements to our contracts. We have sharing mechanisms in place in our long-term local authority contracts where returns exceed contractual hurdle levels. The contract to operate the recycling assets on behalf of GMWDA has entered a run off period of no less than 18 months from 1 October 2017 while they tender for a new contract expected to commence in 2019. Viridor has been shortlisted for two of the three lots being tendered, including the operation of the main processing assets. Performance of major local authority contracts was in line with expectations. Our collections business continued to provide a valuable service to our customers during the year and secured volume for our ERF, landfill and recycling assets.

Joint ventures

Viridor Laing Greater Manchester (VLGM), a joint venture between Viridor and John Laing, performed in line with expectations during the first half year. As part of the contract exit, the company was sold to GMWDA at the end of September and as a result is no longer a joint venture.

The TPSCo joint venture (between Viridor, John Laing and Inovyn) performed strongly with good availability throughout the year. As part of the wider contract reset, GMWDA provided finance to the joint venture to enable the repayment of external bank debt. This change in cash flows resulted in the recognition of income in this joint venture, with an amount deferred relating to the lower ongoing gate fee. A new seventeen-year contract between TPSCo and GMWDA was signed during the year securing fuel supply for the ERF over the period covered by the previous contract. Viridor's operating contract for TPSCo's Runcorn I ERF remains unchanged.

The Lakeside ERF (a 50:50 joint venture with Grundon Waste Management) continued to perform strongly. In its eighth year of operation, it continues to exceed its original targets for both waste processing and power generation.

Community engagement

Viridor continues to invest in educational programmes and support community initiatives in the localities of our operational sites. We have 11 educational centres which received 17,496 visitors in the year ending 31 March 2018. We helped to deliver 93 outreach events.

One of our most prominent educational facilities is our visitor centre at Ardley ERF, a few miles north of Oxford. It runs tailored educational programmes to teach children and adults about sustainable waste management and how energy recovery fits into the waste hierarchy. In April 2018, we were longlisted for the Education Partnership Award as part of Business in the Community's Responsible Business Awards 2018.

We also run community liaison groups that engage in effective dialogue with community representatives. These ensure we keep in touch with our neighbours and give back to the local communities in which we operate. We use these groups to provide updates on our operations and respond to feedback. Wherever possible, we have an open-door policy so that people can see how we are transforming waste in their own community.

During 2017/18, Viridor provided £76 million to community support, sponsorship and charitable donations. Some £7.3 million of this was paid to Viridor Credits for distribution via the Landfill Communities Fund.⁽¹⁾

Our charitable donations scheme helped 114 projects supporting STEM, environmental, resource and recycling education initiatives, communities coming together through sport and community events and communities focused on improving the quality of life for disadvantaged and priority groups.

We have exceeded our three-year goal to deliver 1,500 hours of volunteering within the local community by 2018. In 2017/18, our employees volunteered 123 days. Viridor won the Taunton Deane Business Award (TDBA) CSR Award 2017 for our community partnership with the Somerset Wildlife Trust.

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

Our operations

Water and wastewater

We are focused on providing services in the most efficient and sustainable way possible. Innovation, new technologies and the pioneering of an holistic approach underpins our commitment to delivering service improvement and long-term value.

READ MORE ONLINE
www.southwestwater.co.uk

Upstream catchment

Managing quality and quantity of water running off the land and into the rivers and reservoirs.

Raw water reservoirs/ water resources

Stores an available and sufficient supply of untreated water collected from rivers and a small number of bore holes.

“ We continued to deliver strong performance in 2017/18, providing high-quality drinking water, beating our leakage targets, driving improvements in our environmental standards and delivering improvements in customer service. We are confident in our preparations for the 2019 Price Review (PR19). ”

Stephen Bird

Managing Director, South West Water

South West Water

1.7

million total population served

0.8

million customers

21

raw water reservoirs

15,401

km of drinking water mains network

651

wastewater treatment works with 63 ultraviolet (UV) treatment facilities

29

drinking water treatment works with 3 UV treatment facilities

17,439

km wastewater mains network

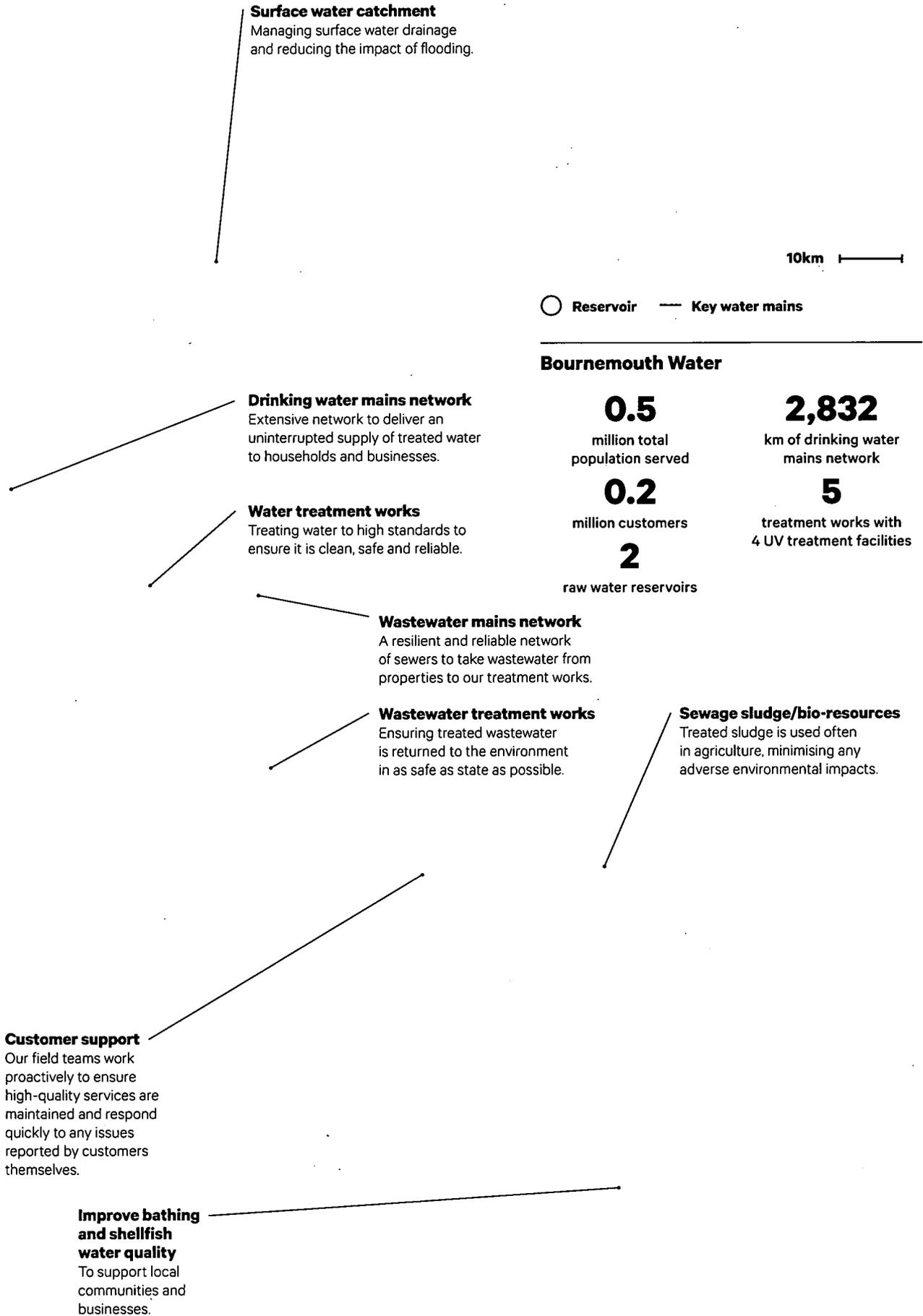
144⁽¹⁾

bathing waters and 24 shellfish waters

30km 

 Reservoir  Key water mains

(1) Assessments were carried out at 143 of these during the year



Our operations

Water and wastewater continued

Sector-leading outperformance

We continued to deliver sector-leading performance in 2017/18 with a cumulative return on regulated equity (RoRE) of 11.8%. This industry-leading performance comprises 6.0% as the base return, 2.6% total expenditure (totex) savings and efficiencies, and 0.3% as a net reward on outcome delivery incentives (ODIs). The remaining 2.9% reflects the difference between actual and assumed financing costs using a cumulative forecast retail price index over K6 of 2.8%, consistent with the way we calculate our innovative WaterShare mechanism.

Total expenditure savings

During 2017/18, we continued to deliver further efficiencies and cost savings with £177 million of cumulative totex savings in the first three years of K6 (2015-2020). We expect to remain at the forefront of cost efficiency in the water sector.

We continued to deliver sector-leading performance in 2017/18.

We use new technology, innovative processes, skills training and equipment to deliver both drinking and wastewater improvements. Savings are driven by continuing advantages from our strategic alliances including a new water distribution framework and the H50 capital alliance. We are ensuring efficient capital investment through the use of data analytics, optimising capital and operating solutions while promoting efficient off-site build techniques. The integration of Bournemouth Water continues to drive efficiencies, including delivery of key capital schemes in the region.

ODI rewards

Overall, our operational performance is ahead of our committed performance levels, resulting in continued net reward in ODI despite the challenges from the cold weather in March 2018.

Operational performance for the full-year resulted in a net ODI reward of £2.6 million (£8.1 million cumulatively over three years of K6), reflecting annual equivalent RoRE outperformance of 0.3% to date.

We maintained good asset reliability and stable serviceability across all water and wastewater areas and received rewards for bathing water quality and water restrictions. Following improvements in external and internal sewer flooding from last year, we received a reward for performance this year.

The cumulative net reward of £8.1 million comprises £10.4 million of net rewards recognised at the end of the regulatory period and £2.3 million of net penalty which may be reflected during the regulatory period.

Pollution events in wastewater, while improving, continue to be higher than the levels to which we have committed and we are targeting further improvements over the remaining regulatory period.

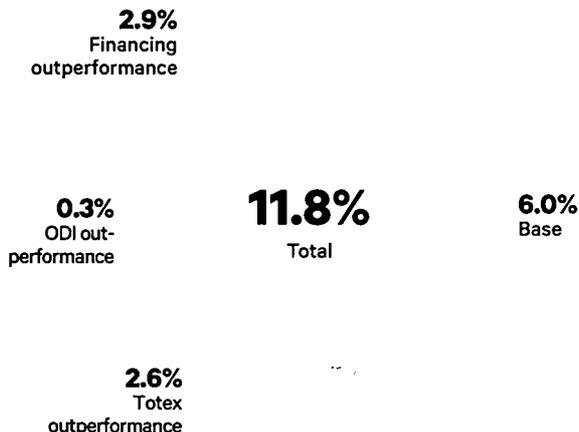
Delivering excellent customer service

We aim to deliver the highest levels of customer service. South West Water's overall customer satisfaction score remains strong at 91%. Value-for-money satisfaction has also increased from last year.

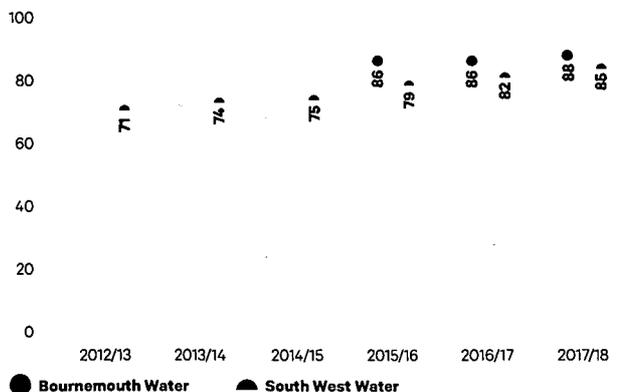
South West Water achieved its highest ever service incentive mechanism (SIM) score of 84.5 (giving a reportable score of 85) while Bournemouth Water's SIM score of 87.6 (a reportable score of 88) remains one of the best in the UK. The SIM score is calculated using a qualitative element (based on a customer survey) and a quantitative element including the number of complaints received in writing or by phone. Complaints have halved since 2011 with written complaints down again in 2017/18 following the c.30% reduction in 2016/17.

During 2017/18 we introduced a number of proactive customer service improvements. These included the in-house development of our 'voice of the customer' (VoC) technologies, designed for use as a transactional (retail) survey and customer engagement tool, innovatively

Cumulative K6 RoRE



SIM



adapted to fit with the unique needs of the wholesale area of our business. The technology has helped us increase the speed and quality of our responses through a more proactive, tailored approach. In conjunction with a wide-ranging number of process, people, technology and proactive customer service improvement initiatives implemented during the year, this has seen South West Water achieve a larger in-year increase in its Customer Experience Survey score (which is an industry comparison of customer service) than any other water company.

In April 2018, South West Water received accreditation from the Institute of Customer Service (ICS). ServiceMark is a national standard recognising an organisation's achievement in customer service and its commitment to upholding those standards. This is a key development because the next generation of Ofwat's SIM mechanism – its customer experience measure known as CMEx (customer measure of excellence) – is likely to be based on the ICS metrics and principles.

A cornerstone of our customer service strategy is to ensure affordable bills and help customers in vulnerable circumstances. We introduced a new social tariff into the Bournemouth region during the year and now assist approximately 51,000 customers through a variety of support schemes.

WaterShare

Our unique WaterShare scheme identified £6.1 million of customer benefits during the year, in addition to the £4.0 million identified for 2016/17. The independent WaterShare customer panel scrutinises our performance against the current business plan and reviews and challenges our recommendations on how any benefits should be shared with customers. It recommended the £4.0 million should be deferred to facilitate investments planned later in the regulatory period. The WaterShare panel will consider how to apply the 2017/18 benefit following customer research later in the year.

ODI net penalties valued at £2.1 million, which apply in the current regulatory period, have been passed back to customers through a reduction to their bills in 2018/19.

Q Co-creation workshops improve customer service on leaks

Customers are understandably concerned about leaks on their supply pipes because they do not want to be charged for water they have not used. Our collaborative 'co-creation' workshops have allowed us to re-engineer the way we respond to customers when they have leaking pipes. Our customers get a better experience and this has increased our customer service scores. Effective use of a range of communication channels including SMS, apps and social media has allowed us to respond faster and ensure customers are kept fully informed throughout the response process. Independent Ofwat surveys have confirmed we are offering a much more responsive process and fulfilling our service commitments.

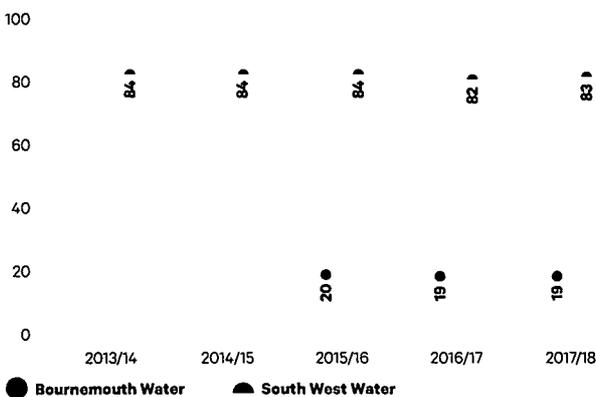
Drinking water

We continued to maintain the high standards of drinking water quality achieved last year. South West Water's leakage performance at 83 megalitres per day was ahead of our target and resulted in a reward for the year. This reflects our continued investment in real-time pressure management and additional network monitoring and effective repairs.

South West Water achieved its 21st consecutive year of unrestricted water supplies, while the Bournemouth Water region has had no water restrictions since privatisation. This is a result of prudent water resource management, keeping leakage under control and high levels of water meter adoption, which helps customers to manage their consumption. Our long-term draft water resource management plan, published in 2017, includes a stress-tested forecast surplus of supply over demand.

The average duration of supply interruptions per property for South West Water was higher than last year as a result of the extreme cold weather in early March 2018. This resulted in a penalty of £0.9 million.

Leakage megalitres per day



Our operations

Water and wastewater
continued

Q Protecting water quality in Plymouth Sound

Our wastewater investment during the year included £20 million in Plymouth to help further protect bathing water quality. We have made significant upgrades to our wastewater infrastructure to improve water quality in Plymouth Sound and maintain bathing water quality at Plymouth Hoe East and West beaches, which have been rated excellent every year since tougher new standards were introduced in 2015. Investment included improving key stormwater overflows, removing surface water and increasing stormwater storage capacity. UV disinfection technology has also been installed on the stormwater overflow at Plymouth Central wastewater treatment works – the largest UV scheme of its type in the UK.

Investment in drinking water infrastructure

Investment into key drinking water projects continued during the year to assist in maintaining water quality and reducing supply interruptions. This work includes improving mains in the Plymouth area as well as our £60 million investment in the innovative Mayflower water treatment works at North Plymouth, which is due to become operational in autumn 2018. We also completed improvements at three water treatment plants in Devon: Tottiford £6.0 million; £6.3 million at Northcombe; and in June 2017, work started on the £5.7 million upgrade of Tamar Lakes treatment works. All three use granular activated carbon filtration and UV disinfection. We continued to invest in real-time pressure management and network modelling technology to reduce supply interruptions.

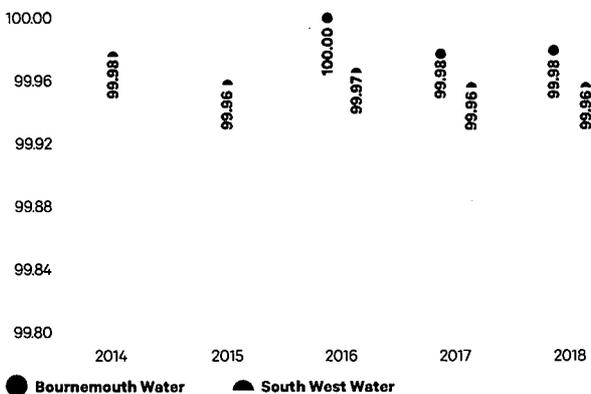
Wastewater

We aim to ensure the safe and efficient removal and disposal of wastewater, while minimising the likelihood of sewer flooding or pollution affecting homes, businesses or the environment. Wastewater treatment improvements were a focus again this year along with increased monitoring to improve our ability to prevent potential failures. A good example is our £5 million investment in wastewater treatment in Fluxton, East Devon, which was completed in January.

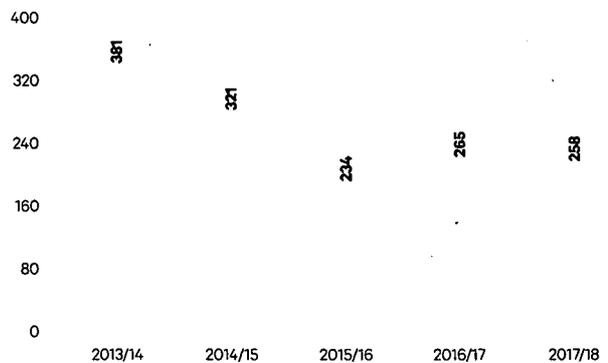
We continue to reduce the risk of flooding to customers.

Although our numeric compliance was slightly down on the previous year's 98.4%, the underlying performance shown by lead indicators and our internal monitoring results continue to improve.

Drinking water quality mean zonal compliance (%)



Pollutions (Categories 1-4)⁽¹⁾



(1) Category 1-4 water and wastewater pollutions.

Protecting the environment

Investment to continue improving environmental performance saw a reduction in overall pollution incidents during the year. While performance still needs to improve, and we incurred a penalty this year, we made good progress and anticipate further improvement in 2018/19.

During the year, a thorough analysis of our historical performance regarding pollution incidents and their root causes was undertaken. New predictive computer models anticipate where blockages might arise and locate them before they become an issue. South West Water is investing in improvements at wastewater treatment works and pumping stations. New capabilities for assessing and clearing sewage network blockages are being introduced in addition to training to increase understanding among employees of the causes and impacts of pollution incidents.

We also continue to promote responsible sewer usage with our customers through initiatives such as Think Sink! and Love your Loo.

In April 2018, South West Water was longlisted for the Environmental Sustainability Award as part of Business in the Community's Responsible Business Awards 2018.

Investment in wastewater infrastructure

Wastewater activity during the year included a £20 million investment in Plymouth to improve the already high level of bathing water quality. We created extra storm storage in the sewerage network helping to reduce the risk of spills into Plymouth Sound, while protecting the already excellent water quality against extreme rainfall events in the future. The project includes construction of our largest ever ultra-violet disinfection facility for storm water and represents the largest single wastewater investment in the current K6 programme.

We improved water quality at eight shellfish harvesting areas on major estuaries in Devon and Cornwall and investment in providing higher capacity and better resilience at our wastewater treatment works, including Hayle in Cornwall, is ongoing, while monitoring of our network during weather events has been enhanced.

Our positive results for the 2017 bathing water season, assessed under EU standards, reflect a sustained programme of major investments to protect bathing waters. Of the 143 bathing waters assessed in the South West Water region, 140 (98%) were classified as 'sufficient' or better, with 75% qualifying as 'excellent'. None of the three bathing waters rated as 'poor' was attributed to any failure of South West Water's assets.

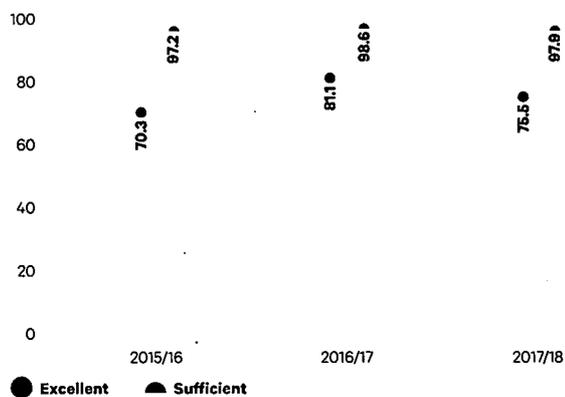
We continue to reduce the risk of flooding to customers through numerous improvements to our sewage system in a range of locations, including Totnes and Paignton.

Q Our Mayflower treatment works is a glimpse of the future

This drinking water investment is attracting widespread interest from other UK water companies as well as overseas. Mayflower will use innovative water treatment processes to deliver even cleaner water more efficiently, while helping to keep customer bills down. A first of its kind in the UK and Europe, Mayflower's new technology combines suspended ion exchange, inline coagulation and ceramic membrane technology. These cutting-edge treatment processes were developed by the Dutch water technology company PWNT. Mayflower combines three of our core values: 'progressive' (the innovative use of robust new technology and a fresh approach to water treatment); 'collaborative' (working in partnership); and 'responsible' (Mayflower will produce renewable energy on site, use fewer chemicals and produce less waste than a conventional treatment works).

READ MORE ONLINE
www.southwestwater.co.uk/mayflower

Bathing water compliance⁽²⁾ (%)



(2) 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).

Our operations

Water and wastewater continued

Q New wastewater van fleet brings immediate drop in pollution incidents

The 2017/18 reduction in pollution incidents results from a range of investments, including a new fleet of specialised wastewater vans. Each van accommodates advanced equipment including CCTV and sonar to detect blockages in wastewater pipes. The vans were commissioned in September and South West Water recorded an immediate reduction in pollution incidents.

We are also running information campaigns such as Think Sink! and Love Your Loo to educate the public about the blockages that can arise when flushing waste fat or baby wipes away.

The Environment Agency is looking for serious pollution incidents across the UK to 'trend towards zero' by 2020 and we continue to look for innovative ways to reduce the number of such incidents.

Customer engagement for PR19

In September 2018 South West Water will submit its business plan for the 2020-2025 period to Ofwat as part of PR19.

In support of PR19 business planning, the company has carried out its largest programme of customer research and engagement to date, including inviting all customers to have their say on business proposals published for consultation in March 2018 through traditional and digital channels, including social media. Feedback has been received from more than 22,000 customers.

Wholesale services

As a wholesaler within the non-household market, which opened on 1 April 2017, we currently work with more than 16 different retailers, including Pennon Water Services, and our wholesale service desk has been operating effectively. As a wholesaler in this new market, we welcome the opportunity to facilitate competition.

Our community

As one of the largest companies in the region, South West Water provides services that are essential for the area's economic sustainability supporting the employment of some 5,000 people either directly or indirectly through our supply chain. We engage with local communities through a range of activities including our own events, support for events run by our partners in Devon and Cornwall and fundraising for charities. Our community outreach also includes public information campaigns including Think Sink! and Love Your Loo, and customer consultations such as our Get Into Water programme as part of our PR19 work.

Sponsorships and charitable partnerships

In 2017/18, South West Water provided £97,000 of community sponsorship and supported a number of charities. Sponsorships included BeachCare with Keep Britain Tidy, Cornwall Wildlife Trust, Devon Wildlife Trust, South West Coast Path Association, Surf Life Saving GB and Beach Schools South West. Our charity activity was on behalf of Age UK Cornwall, Age UK Devon, Cornwall Air Ambulance Trust, Devon Air Ambulance Trust, Devon and Cornwall Food Action and the RNLI.

Access and recreation

Our partnership with South West Lakes Trust ensures that our reservoirs and landholdings are managed for environmental improvements and for the benefit of our customers and communities. During the year we welcomed over two million visitors to our recreational estate. There was a big focus on health and wellbeing with 70,000 people benefiting from health giving outdoor activities at the lakes while 5,000 people learnt new skills as the Trust delivered training workshops in watersports, environmental and heritage education.

Our operations

Water retail services

Pennon Water Services provides water retail and consultancy services across Great Britain to more than 160,000 business customer accounts.

On 1 April 2017 the business retail market for water and wastewater services opened for competition, allowing more than 1.2 million businesses, charities and public sector organisations in England to choose who they buy their water and wastewater retail services from, for the first time.

The wholesale suppliers of water and wastewater services are the same, and domestic retail services remain unaffected.

Pennon's water retail operation

In order to benefit from the introduction of competition, Pennon Water Services was established and formed a retail venture with South Staffordshire plc (incorporating South Staffs Water and Cambridge Water) to build scale and efficiency in the new market. Pennon Water Services is licensed by Ofwat and has achieved excellent adherence to regulatory standards. Pennon Water Services is managed independently of South West Water and can secure services from any wholesaler in the UK.

Operational successes

Pennon Water Services now looks after 5.3% of the UK's business customer accounts having been responsible for 33% of all water-only accounts that switched to combine water and wastewater services under a single retailer. It is one of only four retailers who were previously part of a water company to have achieved net growth in the new, competitive non-household market. 437,000 bills have been issued with over 71,000 customer calls answered. We continue to support key sectors in health, education, manufacturing and agriculture with products designed to help businesses better understand, enhance and protect their water supply. This allows businesses to save money and be more competitive while supporting our continued drive for environmental sustainability.

Over the last 12 months, we have won a number of high-profile, national contracts including Moto, Unite Students and BMI Healthcare, and has been recognised as one of the top four 'champion' performers in the new market by independent consultant Brodick, based on size and growth. We have also been rated highly by customers, scoring 96% customer satisfaction with staff service and 95% customer satisfaction with staff knowledge.

Pennon Water Services has been able to maximise its value by offering a broad range of services to business customers under its AquaCare brand, including legionella testing and prevention, leakage reduction and contingency planning while at the same time creating an opportunity to introduce services from other Pennon Group companies.

Q Source for Business

Source for Business was originally established in 2011 as the specialist business customer division of South West Water, fusing decades of operational excellence with exemplary customer service.

With the deregulation of the water and wastewater retail market in April 2017, Source for Business now operates as the national trading brand of Pennon Water Services.

 **READ MORE ONLINE**
www.sourceforbusiness.co.uk

5.3%
of the UK's business customer
accounts serviced

160,000
business customer accounts
nationwide

Report of the Chief Financial Officer

Financial review

Susan Davy
Chief Financial Officer

“Our sustainable approach to finance is a key contributory factor towards continued and controlled progress against strategic objectives.”

Overview

Pennon Group had another year of strong financial performance in 2017/18, reflecting continuing outperformance against the K6 business plan at South West Water and increasing earnings at Viridor, primarily from its energy recovery facility (ERF) portfolio. This continues to underpin our 10-year dividend policy of 4% year-on-year growth above retail price inflation (RPI) to 2020. Viridor's ERF portfolio remains a key differentiator for Pennon compared with our peers in the water sector. The expansion of ERF earnings, with further facilities being commissioned against a background of under-capacity in the market will play a major role in supporting the Group's earnings growth to 2020 and beyond.

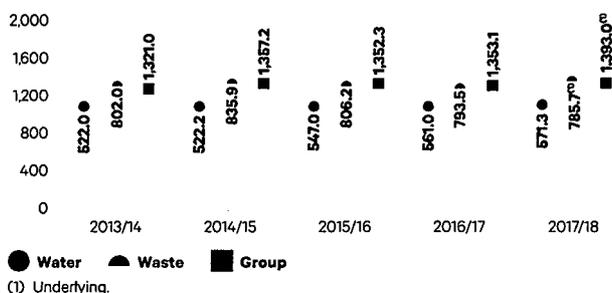
Pennon's financial performance, balance sheet and dividend are aligned to our strategic sustainability objectives. The publication of our refreshed tax strategy in March 2018, ensuring we contribute to society through a responsible approach to tax and the refinancing of our £300 million perpetual capital securities in September 2017 demonstrate our commitment to sustainable financing. In addition, Pennon has pioneered a sustainable financing framework to integrate commitments to environmental and social objectives into a variety of funding opportunities across the Group. Our sustainable approach to finance is a key contributory factor towards continued and controlled

progress on delivery against our strategic objectives to lead the UK's water and waste sectors, invest for growth and drive value through efficiency.

South West Water, including the merged Bournemouth Water business, continues to deliver and outperform the sector leading business plan targets for the current K6 regulatory period and achieved a return on regulated equity (RoRE) of 11.1% for the year (11.8% cumulatively). This result is achieved through outperformance spread across total expenditure (totex) savings, financing with the lowest effective rates in the industry and delivery of net outcome delivery incentive (ODI) rewards; and through the unique WaterShare mechanism the benefits of outperformance are being shared with our water customers. £79 million has been identified for sharing with customers to date. Within the context of totex outperformance of £177 million to date in K6, South West Water is also delivering on its targeted capital expenditure programme with a major investment in the innovative new Mayflower water treatment works for Plymouth now nearing completion, investment in Plymouth Bathing Waters where specific improvements are maintaining the high level of bathing water quality in that area and improvements at three other water treatment works including the installation of granular activated carbon (GAC) filtration technology.

With Ofwat's PR19 Price Review widely anticipated to be challenging to the industry (with the Final Methodology signalling reduced allowed returns, but with strong operational and customer service incentives for good performing companies) South West Water is making good progress with its 2020-2025 business plan. The company's multi-channel customer engagement campaign 'Get into Water' is well underway and a formal customer consultation was launched on 1 March 2018. In developing its detailed plans the business is confident in its ability to remain at the frontier of cost efficiency for the water sector and is focused on maintaining the momentum on cost savings and financing outperformance that it has already achieved to date.

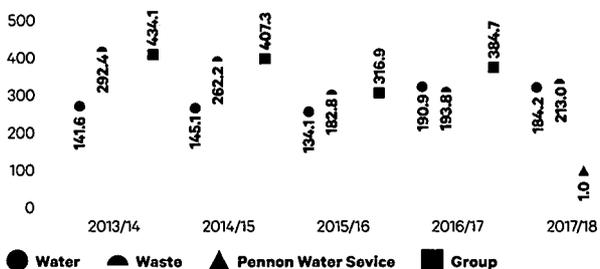
Revenue (£m)



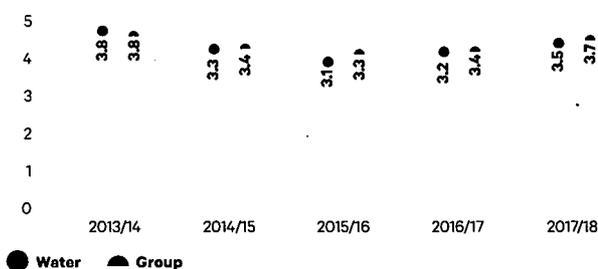
EBITDA (£m)



Capex (£m)



Interest rate on average net debt (%)



Underlying earnings reconciliation 2018

£m	Underlying	Non-underlying items			Earnings per share (p)
		Reset of Greater Manchester contact	Derivative fair value movements	Statutory results	
EBITDA	509.6	3.2	-	512.8	
Operating profit	323.9	3.2	-	327.1	
Profit before tax	258.8	6.5	(2.4)	262.9	
Taxation	(44.4)	3.0	0.4	(41.0)	
Profit after tax (PAT)	214.4	9.5	(2.0)	221.9	
PAT attributable to perpetual capital holders				21.5	
Non-controlling interest				(0.2)	
PAT attributable to shareholders				200.6	48.0
Deferred tax before non-underlying items				18.3	4.4
Non-underlying items post tax				(7.5)	(1.8)
Proportional adjustment on Perpetual capital returns				1.3	0.3
Underlying earnings				212.7	50.9

(2) See reconciliation on page 44.

Underlying earnings reconciliation 2017

£m	Underlying	Non-underlying items				Statutory results	Earnings per share (p)
		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
Underlying earnings						194.3	47.0

Report of the CFO

continued

Adjusted EBITDA reconciliation

£m	2018	2017
Statutory EBITDA	512.8	475.3
Non-underlying items	(3.2)	10.7
Underlying EBITDA	509.6	486.0
IFRIC 12 interest receivable ⁽¹⁾	13.8	16.1
JV EBITDA ⁽¹⁾	33.2	32.9
JV IFRIC 12 interest receivable ⁽¹⁾	5.7	11.2
Adjusted EBITDA	562.3	546.2

(1) These adjustments relate to the waste management business, resulting in adjusted waste management EBITDA of £202.9 million (2016/17 £198.5 million).

Viridor performed well in the year, with particularly strong performance from its ERFs, with the operational part of our portfolio consistently achieving availability of 92%⁽²⁾ and outperforming initial base case expectations. The majority of Viridor's capital investment continues to relate to the delivery of the four remaining ERFs.

The recycling market environment remains challenging, with operational costs increasing to meet operational requirements and the impact of China's new import policy (impact of c.£3 million in 2017/18).

Austerity measures faced by Viridor's local authority customers continue to create pressure for them and emphasise the importance of continuing delivery of efficiency and value for money.

During the year, Viridor negotiated a reset to the Greater Manchester waste contract which had a mutually positive outcome. Following the changes in contractual arrangements it is anticipated that future annual earnings will reflect:

- No further finance income or share of profit after tax will be recognised from Viridor Laing, as the entity is no longer part of the Group
- A non-material reduction in profit after tax and finance income from TPSCo shareholder loans due to a reprofiling of cash flows
- Improved earnings from the recycling asset operations contract over the 18 month run-off period.

The Group's subsidiary Pennon Water Services has successfully gained new customers since the opening of the non-household retail market to competition on 1 April 2017. Pennon Water Services operates independently of South West Water and can secure services from any UK wholesaler, while South West Water has the freedom to supply other UK business retailers.

Pennon remains focused on driving greater synergies and savings across the Group, sharing best practice and ensuring it is well placed to capitalise on emerging opportunities. A good example is the successful implementation of a Group-wide enterprise resource planning system. The cost savings and synergy targets of c.£17 million p.a. from 2019, identified by the Group's Shared Services Review, is on track and the run rate is already c.£13 million p.a.

In the water business in particular, we see consolidation as a sustainable way to deliver greater efficiency, lower bills and delivering benefits for customers. This has been demonstrated through the Bournemouth Water integration with c.£27 million of cumulative synergies targeted by 2020, of which £16 million has already been delivered through a 25% reduction in back office costs and sharing best practice improving performance.

Balancing operational risk and reward remains a key component of our financial and business strategy. Across our operations, we are successfully reducing Group risk by overlaying our long-term assets with long-term commercial arrangements and supporting these with long-term financing. This applies to any aspect of the Group's operations – new investments in our water business, working with local authorities on long-term waste solutions, our investment into the Avonmouth ERF, or the Group's entry into the UK's non-household retail market. This policy is enhancing the Group's resilience and sustainability.

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. In September 2017, the Group issued £300 million of perpetual capital securities recognised as equity. The issue achieved a coupon rate of 2.875% and was four times oversubscribed. This new issue refinanced the same amount raised as perpetual capital securities in March 2013 (which had also been treated as equity and has now been repaid). As a result of this issue, the flexibility of our balance sheet has been enhanced. Our decision in the first half of 2017/18 to stop offering a scrip dividend in lieu of cash underlines the strength of the Group's balance sheet.

During the year our interest rate on average net debt remained relatively low at 3.7% and at 31 March 2018 the Group continued to have a strong funding position with £1,171 million of cash and committed facilities.

Statutory financial performance

The Group's statutory results showed growth in both profit before tax to £262.9 million (2016/17 £210.5 million) and earnings per share to 48.0p (2016/17 39.8p). This reflects strong earnings from both South West Water and Viridor, supported by sector leading efficiencies in the water business and high availability from Viridor's ERFs. The performance of the underlying business is set out in more detail below in the financial performance section.

(2) Weighted by capacity, excludes Bolton, includes JVs at 100%.

The statutory results include the impact of non-underlying items totalling a credit after tax of £7.5 million (2016/17 £11.1 million charge). The Directors believe excluding non-underlying items and deferred tax provides a more useful comparison on business trends and performance.

The net non-underlying credit of £7.5 million is a result of:

- Reset of Viridor's Greater Manchester contracts – credit of £6.5 million, representing a gain on the re-profiling of cash flows (£22.5 million), favourable settlement of all construction related claims (£3.2 million) net of a write-down of shareholder loans (£19.2 million)
- The movement in the fair value of long-dated derivatives associated with South West Water's 2040 bond giving a charge of £2.4 million (2016/17 credit of £16.0 million)
- Taxation on the non-underlying items above totalling a credit of £3.4 million.

Financial performance (before non-underlying items)

Revenue

Group revenue increased by 2.9% to £1,393.0 million (2016/17 £1,353.1 million). Revenue from the water business was up by 2.9% to £571.3 million (2016/17 £555.3 million) due to net tariff increases of 2.5%⁽³⁾ and customer demand increasing by 0.2% from drier weather and increased infrastructure connections. Viridor's revenue marginally decreased to £785.7 million (1.0%) (2016/17 £793.5 million) principally due to lower landfill tax on lower landfill volumes and lower recycling sales offset by higher ERF sales as the fleet of ERFs performed strongly. Around 2% of the Group revenue increase is attributable to non-household customer accounts related to the retail book acquired from South Staffordshire by Pennon Water Services (the new retail venture with South Staffordshire owned 80:20).

Adjusted EBITDA

Group underlying EBITDA and adjusted EBITDA were ahead of 2016/17 up 4.9% at £509.6 million (2016/17 £486.0 million) and 2.9% to £562.3 million (2016/17 £546.2 million) respectively. Underlying operating profit increased by 6.3% to £323.9 million (2016/17 £304.6 million) and underlying profit before tax increased by 3.5% to £258.8 million (2016/17 £250.0 million). This has been achieved through increases in profits from both Viridor and South West Water, together with continuing efficient ongoing finance costs across the Group.

South West Water's EBITDA and operating profit increased by 3.8% and 5.9% respectively. Tariff rises and increased customer demand (up 0.2% from last year) net of meter switchers has driven an increase in revenue. Operating costs increased but at a lower rate of increase than inflation of 3.7% as a result of targeted efficiencies and other savings. In addition, South West Water's bad debt performance remains strong with a charge of 0.8% of revenues (2016/17 1.1%) reduced from 1.7% at March 2015.

This continues to be driven by efficient collections as we work with our customers to manage their debt and strive to support those customers in vulnerable situations with affordability challenges. South West Water has continued to record strong performances against the K6 regulatory contracts, outperforming regulatory assumptions resulting in a cumulative RoRE of 11.8%. More detail on RoRE performance is set out on page 36.

Pennon Water Services has successfully gained new customers since the opening of the non-household retail market to competition on 1 April 2017. During 2017/18, service investment and set up costs of c.£1.5 million have been recognised relating to the successful migration to a single billing system and customer service operation for those customers previously served by South West Water and South Staffs Water. Overall EBITDA for the year is £1.0 million.

Viridor has delivered an increase in EBITDA of 8.6% to £150.2 million (2016/17 £138.3 million) through improved performance of existing assets and a focus on quality and efficiency.

The ERFs have performed strongly during the year with availability of 92%⁽⁴⁾. ERF EBITDA was £123.7 million (2016/17 £106.9 million) increasing 15.7%, due to like for like facilities contributing a 9% increase with the remainder reflective of the financial contribution from Dunbar ERF. Performance of the facilities is above initial base case assumptions. During the year ERF earnings included contractual compensation of £12.1 million, a similar level to last year.⁽⁵⁾ IFRIC 12 interest receivable has reduced to £13.8 million (2016/17 £16.1 million) as the financial assets are paid down through the operational phase of the contracts.

Joint venture EBITDA has decreased by 11.8% to £38.9 million (2016/17 £44.1 million). This is as a result of strong performance in TPSCo and Lakeside, offset by the impact of the Greater Manchester contract reset where Viridor disposed of its shares in Viridor Laing (Greater Manchester) Holdings Limited. Viridor Laing contributed EBITDA of £7.5 million prior to disposal (2016/17 £14.4 million).

Landfill EBITDA has dropped since 2016/17 as volumes have decreased, though the rate of volume decline has slowed. The volumes observed in the first half of the year were stronger but have reduced slightly during the second half. However, the demand for a landfill solution remains resilient, therefore four new cells were constructed in the year. EBITDA at £5.6 million is 13.8% lower than last year (2016/17 £6.5 million).

As we reported at the half year, we have been investing in our Landfill Gas business to enhance the long-term reliability of our assets. As a result of the required shutdowns there have been consequential impacts to revenue (lower availability) and costs. EBITDA for the year is £23.3 million, down 15.6% from the prior year (2016/17 £27.6 million).

(3) Tariff increase reflects the net position post wholesale revenue forecast incentive mechanism (WRFIM) pass back of £10.9 million.

(4) Weighted by capacity, excludes Bolton, includes JVs at 100%.

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

Report of the CFO continued

EBITDA for recycling has reduced by £7.7 million from £22.7 million to £15.0 million. The recycling market has been challenging, with operational costs increasing to meet quality requirements and the impact of China's new import policy. Self-help measures are focusing on asset and contract optimisation, innovation and accessing new markets. This has contributed to an increase in average revenue per tonne. Of the EBITDA reduction in the year, around £3 million related to the pricing and quality implications of China's policy announcement. The remaining reduction of £4.7 million reflects an overall reduction in recycling volumes and increase in processing and reject costs as a result of local authority cost savings impacting input quality, and higher output quality demands. Consequently EBITDA per tonne has fallen to £11 (2016/17 £14). Revenue per tonne is up 7.8% to £97 (2016/17 £90), reflecting a mix change towards higher value product, including polymers and higher-grade paper. Operational cost per tonne has increased by £11 to £83 (2016/17 £72). Compared with the second half of 2017/18 we anticipate market and operational improvements into 2018/19.

Viridor also continues to work with customers to improve performance levels and is incentivised to work together to find mutually beneficial solutions including through income sharing mechanisms, in particular with our long-term local authority clients. The agreement of solutions that give a positive outcome for Viridor as well as our customers has contributed to a 15.2% increase in EBITDA from Contracts, Collections and Other to £39.3 million (2016/17 £34.1 million).

Group efficiencies achieved as a result of the Shared Services initiatives have delivered a further £4 million of cost savings and synergy benefits during the year bringing the cumulative position to c.£13 million p.a. to date, and is on track for the cumulative c.£17 million p.a. targeted from 2019.

Across the Group we look to efficiently manage and optimise value from our estates portfolio, recognising a profit on sale of assets in the year of £2.5 million (2016/17 £7.5 million).

Net finance costs

Underlying net finance costs of £74.5 million were £15.7 million higher than last year (2016/17 £58.8 million). This includes a reduction of c.£8.0 million in other finance income following the unwind of the 2011 Peninsula MB Limited derivative in the prior year, higher RPI on index-linked debt and higher net debt from continuing capital investments.

We have secured funding at a cost that is efficient and effective. RPI funding represents approximately 20% of Group borrowing resulting in higher interests costs as inflation rates have risen, but at 3.7% the Group interest rate on average net debt for 2017/18 remains sector leading (2016/17 3.4%). The effective interest rate is calculated after adjusting for capitalised interest of £17.0 million, notional interest items totalling £11.8 million and interest received from shareholder loans to joint ventures of £7.9 million. For South West Water this figure was 3.5% (2016/17 3.2%).

During the year underlying net finance costs (excluding pensions net interest cost £1.6 million, discount unwind on provisions £10.2 million and IFRIC 12 contract interest receivable £13.8 million) were £76.5 million (2016/17 £64.6 million), covered 4.2 times (2016/17 4.7 times) by Group operating profit.

Profit before tax

Group underlying profit before tax was £258.8 million, an increase of 3.5%, compared with the prior year (2016/17 £250.0 million). On a statutory basis, profit before tax was £262.9 million (2016/17 £210.5 million) reflecting a net non-underlying credit before tax of £4.1 million (2016/17 net charge of £39.5 million). Included in profit before tax is the Group's share of joint venture profit after tax of £9.4 million (2016/17 £4.2 million). Joint venture profit before tax is benefiting from improved performance at Lakeside and Runcorn I ERFs.

Taxation

The Group's underlying mainstream UK corporation current tax charge for the year (before prior year adjustments) was £29.7 million, reflective of an effective tax rate of 11.5% (2016/17 16.5%). The lower effective rate of taxation reflects the level of capital allowances claims available to Viridor on its increased capital expenditure. The 2016/17 effective tax rate included a £10.7 million charge for the 2011 Peninsula MB derivative. There was a prior year credit of £3.6 million recognised for the year (2016/17 credit of £1.8 million). In addition there is a non-underlying £3.0 million current tax credit relating to non-underlying items (2016/17 £9.4 million credit).

Underlying deferred tax for the year (before prior year adjustments) was a charge of £20.7 million (2016/17 £17.8 million). The charge for 2017/18 primarily reflects capital allowances across the Group in excess of depreciation charges. There was a prior year deferred tax credit of £2.4 million recognised for the year (2016/17 £1.1 million charge). In addition there is a non-underlying £0.4 million deferred tax credit relating to non-underlying items (2016/17 £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). The prior year credit related to the enacted reduction in the UK rate of corporation tax to 17% in 2020. There is no change in rate to be recognised for 2017/18.

Overall the total tax charge for the year was £41.0 million (2016/17 £30.0 million).

Earnings per share

Earnings per share on both a statutory and underlying basis⁽¹⁾ were ahead of last year, up 20.6% at 48.0p (2016/17 39.8p) and up 8.3% at 50.9p (2016/17 47.0p) respectively, reflecting higher profits. Net assets per share at book value at 31 March 2018 were 391p, up 7.1% on last year (2016/17 365p).

Dividends and retained earnings

The statutory net profit attributable to ordinary shareholders of £200.6 million has been transferred to reserves.

The Directors recommend the payment of a final dividend of 26.62p per share for the year ended 31 March 2018. With the interim dividend of 11.97p per share paid on 4 April 2018 this gives a total dividend for the year of 38.59p, an increase of 7.3% over 2016/17 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.

(1) Earnings per share before non-underlying items, deferred tax and proportionally adjusted for perpetual capital returns.

The net effect of this policy is that dividends per share should almost double 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 £162.0 million are covered 1.3 times by net profit (before non-underlying items and deferred tax) (2016/17 1.3 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 £1,069 million. The most significant areas of expenditure were:

Expenditure	£m
Employment costs	193
Depreciation	182
Landfill tax	132
Raw materials and consumables*	84
Transport	64
Power	43
Business rates	39
Abstraction and discharge consents	9

* Excludes transport costs.

Group capital investment

Group capital investment was £398.2 million in 2017/18 compared to £384.7 million in 2016/17. The expenditure focused on the regulatory programme for South West Water and ERF build out for Viridor.

Viridor's capital investment in the year was £213 million, £19.2 million higher than last year.

The majority of Viridor's capital investment continues to relate to the delivery of the ERF portfolio, with £168 million of the total spend relating to the four ERFs under construction. Beddington, Dunbar and Avonmouth are all expected to be completed on budget. Solid progress has been made with Doosan Babcock at Glasgow. Completion of the construction of this facility has required a higher level of remediation expenditure than originally envisaged. Cumulative spend of £238 million has been incurred to 31 March 2018 which is higher than the original target of £155 million. Viridor is contractually entitled to recover incremental costs from the original principal contractor, Interserve, under certain circumstances. The Group believes these circumstances have been met and discussions with Interserve are ongoing with regard to the contractual settlement. At 31 March 2018 a receivable of £68.7 million has been recognised. In accordance with IFRIC 12 service concession arrangements, a financial asset of £140.6 million and an intangible asset of £67.6 million have been recognised (including rolled up finance income and capitalised interest), with no operating profit on construction having been taken to date. While there are further possible recoveries that are contingent on future events, these are not currently recognised. The ultimate agreement of the contractual

amount due to the Group from the original principal contractor, including the nature of any receipts and the recoverability of such agreed amounts under the contract, could result in revisions to the receivable and the amounts recorded for the financial asset and intangible assets, including the allocation between the two amounts, which could then impact the margins recognised on this contract over the life of the project to 2043. Internal assessments have been corroborated by legal advice in arriving at appropriate amounts to be recognised on the balance sheet.

Including the £173 million⁽²⁾ total remaining capital expenditure for completion of the ERF portfolio, the total investment in ERFs is £1.5 billion⁽²⁾.

Landfill demand has remained strong and new cells have been constructed at four sites during the year at a cost of £5 million.

South West Water's capital expenditure in the year was £184.2 million compared with £190.9 million in 2016/17 with the slight decrease being in line with the profile of the K6 capital plan. Major features of the programme for the year include:

- The innovative Mayflower water treatment works at North Plymouth with c.£28 million of expenditure in 2017/18 (2016/17 c.£27 million)
- Investment in Plymouth Bathing Waters, delivering targeted improvement to maintain the high level of bathing water quality in that area
- Improvements at three water treatment works including the installation of GAC filtration improving water quality.

The major categories of expenditure were:



(2) Excluding capitalised interest and amounts subject to legal contractual processes.

Report of the CFO

continued

Cash flow

The Group's operational cash inflows in 2017/18 at £672 million were £106 million higher than last year (2016/17 £566 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.

Contributions into the Group's pension schemes for the year were £17 million and corporation tax payments were £22 million. Total tax payments reflecting all taxes borne and collected by the Group in 2017/18 were £265 million, as described in more detail in the section on Tax Contribution 2017/18 – borne/collected on page 50.

Summarised cash flow	2017/18 £m	2016/17 £m
Cash inflow from operations ⁽¹⁾	672	566
Net interest paid	(61)	(62)
Tax paid	(22)	(36)
Other taxes paid	(129)	(110)
Dividends paid (net of scrip)	(108)	(132)
Hybrid payments	(23)	(20)
Capital investment ⁽²⁾	(382)	(363)
Spend incurred on Glasgow Recycling and Renewable Energy Centre	(82)	-
Dividends and loan repayments received from joint ventures	40	5
Pension contributions	(17)	(11)
Equity placing and other share issues	4	2
Acquisition of South Staffs non-household retail customer book	(8)	-
Net cash outflow	(116)	(161)
Debt indexation/interest accruals and other movements	(21)	(20)
Increase in net borrowings	(137)	(181)

(1) Before construction spend on service concession arrangements of £83 million (2016/17 £13 million), pension contributions of £17 million (2016/17 £11 million) and other tax payments of £129 million (2016/17 £110 million). Other taxes include business rates, employers national insurance, fuel excise duty, carbon reduction commitment, environmental payments, climate change levy and external landfill tax.

(2) Including construction spend on service concession arrangements and proceeds from sale of property, plant and equipment. For 2016/17 includes service concession spend on Glasgow.

Liquidity and debt profile

The Group has a strong liquidity and funding position with £1,171 million cash and committed facilities at 31 March 2018. This consists of cash and deposits of £585 million (including £182 million of restricted funds representing deposits with lessors against lease obligations) and undrawn facilities of £586 million. At 31 March 2018 the Group's borrowings totalled £3,387 million. After the £585 million held in cash, this gives a net debt figure of £2,802 million, an increase of £137 million during the year (2016/17 £2,665 million).

In March 2013 the Group issued £300 million of perpetual capital securities recognised as equity. This was refinanced in September 2017 by issuing another £300 million of perpetual capital securities which are also recognised as equity in the financial statements. The new issue achieved a coupon rate of 2.875% (and was four times oversubscribed) and supports an increase in investible capacity to c.£800 million. For the closure of the 2013 perpetual capital securities there was a take up of approximately 95% to the offer of 103% of par plus accrued periodic returns, resulting in cash outflow of £8 million net of the new issuance. The remaining 2013 perpetual capital securities were called at par plus accrued periodic returns with a cash outflow of approximately £15 million settled in October 2017.

Major components of the Group's debt finance at 31 March 2018

	£134m	
	Bond 2040	
	£619m	
	Private placements	
	£323m	
	European Investment Bank (EIB) loans	
	£427m	
	Index-linked bonds	
	£379m	
	Bank bilateral debt	
	£1,505m	
	Finance leasing	
	£3,387m	
	Total	

As a result of the refinance of the perpetual capital securities, statutory earnings per share is reduced by:

- £15.7 million (after tax)⁽³⁾ periodic return on the 2013 issuance, due 8 March 2018, which has effectively been paid to bond holders through accrued payments to the refinance date and the premium to par
- £5.8 million reflecting the periodic return due on the new issuance payable in May 2018. It has been recognised in accordance with the terms of the securities as an ordinary dividend has been paid in the 12 months preceding May 2018.

The costs of issuing the 2013 perpetual capital securities of £5.2 million have been reclassified from the perpetual capital securities reserve to retained earnings. The costs of issuance for the 2017 perpetual capital securities of £3.3 million have been recognised directly in the perpetual capital securities reserve.

(3) The new perpetual capital securities do not qualify for tax relief.

In addition to the refinancing of the perpetual capital securities, during the year £150 million of new and renewed facilities have been signed, £125 million in Pennon Group plc and £25 million in South West Water. In addition, an agreement was signed in the year to release £50 million of previously restricted cash held against lease obligations.

Following European Investment Bank (EIB)/Government discussions, previous EIB approved transactions are being progressed.

Pennon has pioneered a sustainable financing framework to integrate commitments to environmental and social objectives into a variety of funding opportunities across the Group. The framework allows Pennon to access future funding opportunities aligned with the green loan principles, green bond principles and social bond principles. The framework has been certified by DNV-GL a leading sustainability verifier. Pennon is committed to continuous annual improvements in sustainability ratings and KPIs and may lead to improved interest rate margins.

Since the year end £30 million of leases with the use of proceeds focused on innovative Mayflower Water Treatment Works and £80 million of revolving credit facilities have been signed under this sustainable financing framework.

In addition, a further £130 million of new and renewed facilities have also been signed since 31 March 2018.

Following these financing initiatives, Pennon has cash and committed facilities covering the remainder of planned K6 capital spend and our ERF investment programme.

However, funding will be sourced over K6 to:

- Maintain an appropriate headroom of cash and committed facilities, including replacing maturing finance
- Prepare for the next regulatory period

The Group has a diversified funding mix of fixed (£1,740 million, 62%), floating (£502 million, 18%) and index-linked borrowings (£560 million, 20%). The Group's debt has a maturity of up to 39 years with a weighted average maturity of 19 years. 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 at least 50% of funding fixed before the start of a regulatory period.

£505.8 million of South West Water's debt is index-linked at an overall real rate of under 2.0%. South West Water's cost of finance is among the lowest in the industry. Around two-thirds of the water business 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. A quarter of South West Water's net funding is RPI linked, at below Ofwat's notional level of 33% leaving headroom for RPI to CPIH (consumer price index plus housing) transition.

Capital structure – overall position

The Group's net debt has increased by £137 million to £2,802 million. The gearing ratio at 31 March 2018, being the ratio of net debt to equity plus net debt was 63.1% (31 March 2017 63.8%).

South West Water's debt to RCV ratio is 60.3% (31 March 2017 61.8%), which aligns with Ofwat's K6 target for efficient gearing of 62.5%.

Group net debt includes £1,442 million of investment in wholly-owned ERFs (Runcorn II, Oxford, Exeter, Cardiff, Glasgow, Dunbar, South London and Avonmouth). In addition, the amount invested in joint ventures through shareholder loans is £41 million primarily for TPSCo (which together represents c.50% of Group net debt).

Following the Greater Manchester contract reset where all external debt related to Viridor Laing and TPSCo was repaid, Pennon's share of Lakeside's non-recourse net debt from third parties (excluding shareholder loans) stands at £32 million.

Regulatory capital value as at 31 March (£m)



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

Report of the CFO continued

Taxation strategy

Our Tax strategy means that we will:

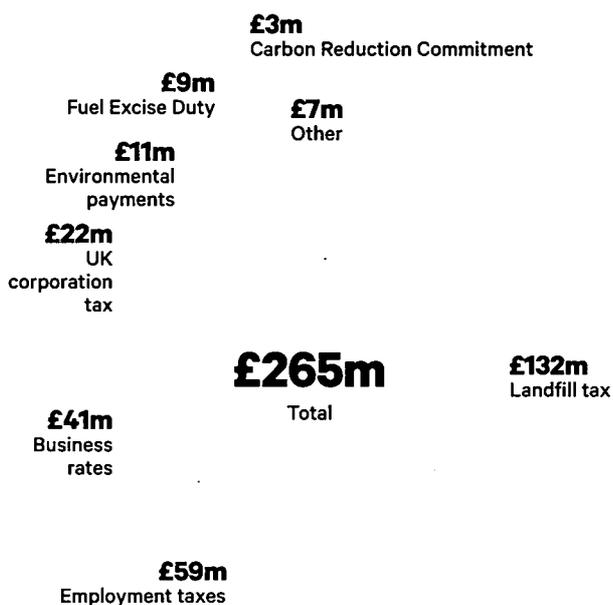
- At all times consider the Group's corporate and social responsibilities in relation to its tax affairs
- Operate appropriate tax risk governance processes to ensure that the policies are applied throughout the Group
- Comply with our legal requirements; file all appropriate returns on time and make all tax payments by the due date
- Consider all taxes as part of ongoing business decisions
- Not enter into artificial tax arrangements or take an aggressive stance in the interpretation of tax legislation
- Not undertake transactions which are outside the Group's low risk appetite for tax or not in line with the Group's Code of Conduct
- Engage with HMRC in a proactive and transparent way and discuss our interpretation of tax laws in real-time, such interpretations following both the letter and spirit of the laws.

The Group's approach to tax planning, risk management and governance is in line with the Finance Act 2016 requirements; the Group does not expect its tax strategy to change significantly year on year, however it is reviewed and updated annually.

Further details are given in the Group's Tax Strategy document available on the Pennon Group website.

Tax contribution 2017/18 – borne/collected

The Group's total tax contribution (TTC) for 2017/18 amounted to £265 million (2016/17 £310 million). TTC is a standardised measure of a group's total tax contribution, having been developed by PwC and the 100 Group (FTSE 100 finance directors). It is acknowledged as being a fair and comparable representation of total tax cost.



Q Our tax strategy explained

In developing our refreshed tax strategy, we consulted customers and members of the public through focus groups and qualitative surveys to assess views of Pennon's corporate responsibility in general and our proposed tax strategy publication. Most of our focus group participants said they welcomed our commitment to a robust and transparent tax strategy, describing our tax contribution as 'fair'. Participants were clear that a company that gets its tax right is highly likely to get other aspects of corporate responsibility right.

As a result of this research, Pennon has: been clear in the tax strategy document about Pennon's approach to tax; sought to make the tax strategy digestible to all; and included real-life examples to demonstrate how the tax approach works in practice.

READ MORE ONLINE
www.pennon-group.co.uk/taxstrategy

TTC looks at taxes borne and taxes collected. Taxes borne includes all taxes which are a cost to the Group, such as business rates, corporation tax and employer's National Insurance contributions (NICs). Taxes collected and recovered highlights where the business is collecting tax on behalf of HMRC. A net amount of £23 million (2016/17 £45 million) was collected on behalf of the authorities for employee payroll taxes and VAT.

Landfill tax of £127 million (2016/17 £145 million) collected and paid on waste material deposited at our landfill sites. The reduction in landfill tax is a result of less waste being deposited to landfill during the year. This amount includes £7 million (2016/17 £6 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 £5 million (2016/17 £2 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 HMRC's tax receipts in the year.

Employment taxes of £59 million (2016/17 £57 million) including employees' Pay As You Earn (PAYE) and total National Insurance Contributions (NICs). Employer NICs of £17 million (2016/17 £16 million) were charged approximately 92% to operating costs with 8% capitalised to property, plant and equipment. The Group also paid £1 million in apprentice levy which was introduced by the Government in April 2017. The total amount of £59 million includes PAYE of £3 million (2016/17 £3 million) on pension payments made by the Group pension scheme. A net amount of £41 million (2016/17 £41 million) was collected on behalf of the authorities for employee payroll taxes.

Business rates of £41 million (2016/17 £39 million) paid to local authorities. This is a direct cost to the Group and reduces profit before tax.

The main elements of the £22 million UK corporation tax payment in the year (2016/17 £36 million) were £11 million in relation to 2017/18 instalment payments and £11 million in relation to earlier years. The reduction in corporation tax payments is due to additional payments being made in prior years to settle open tax enquiries which have now been agreed.

VAT of £19 million has been received (2016/17 £5 million paid) by the Group from HMRC. This is due to an increase in expenditure on ERFs versus the prior year. VAT has no material impact on profit.

Payments to the Environment Agency and other regulatory bodies total £11 million (2016/17 £11 million). This reduces profit before tax.

Fuel Excise Duty of £9 million (2016/17 £7 million) related to transport costs. This reduces profit before tax.

Carbon Reduction Commitment (CRC) payment for the Group of £3 million (2016/17 £3 million). This reduces profit before tax.

Pensions

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

At 31 March 2018 the Group's pension schemes showed an aggregate deficit (before deferred tax) of £49.5 million (March 2017 £68.0 million). The deficit has decreased primarily due to increases in corporate bond yields during the year.

For the Group's principal pension scheme the recovery plan includes annual deficit contributions up to 2022. South West Water accounts for around 80% of the principal scheme.

The net aggregate liabilities of £41 million (after deferred tax) represented around 2% of the Group's market capitalisation at 31 March 2018.

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.

Conclusion

Pennon Group had another year of strong performance. The Group goes forward with a strong balance sheet, sustainable finances, and dividend well aligned to its strategic objectives.

Susan Davy

Chief Financial Officer

Pennon Group plc

Risk report

Risk management and internal control framework

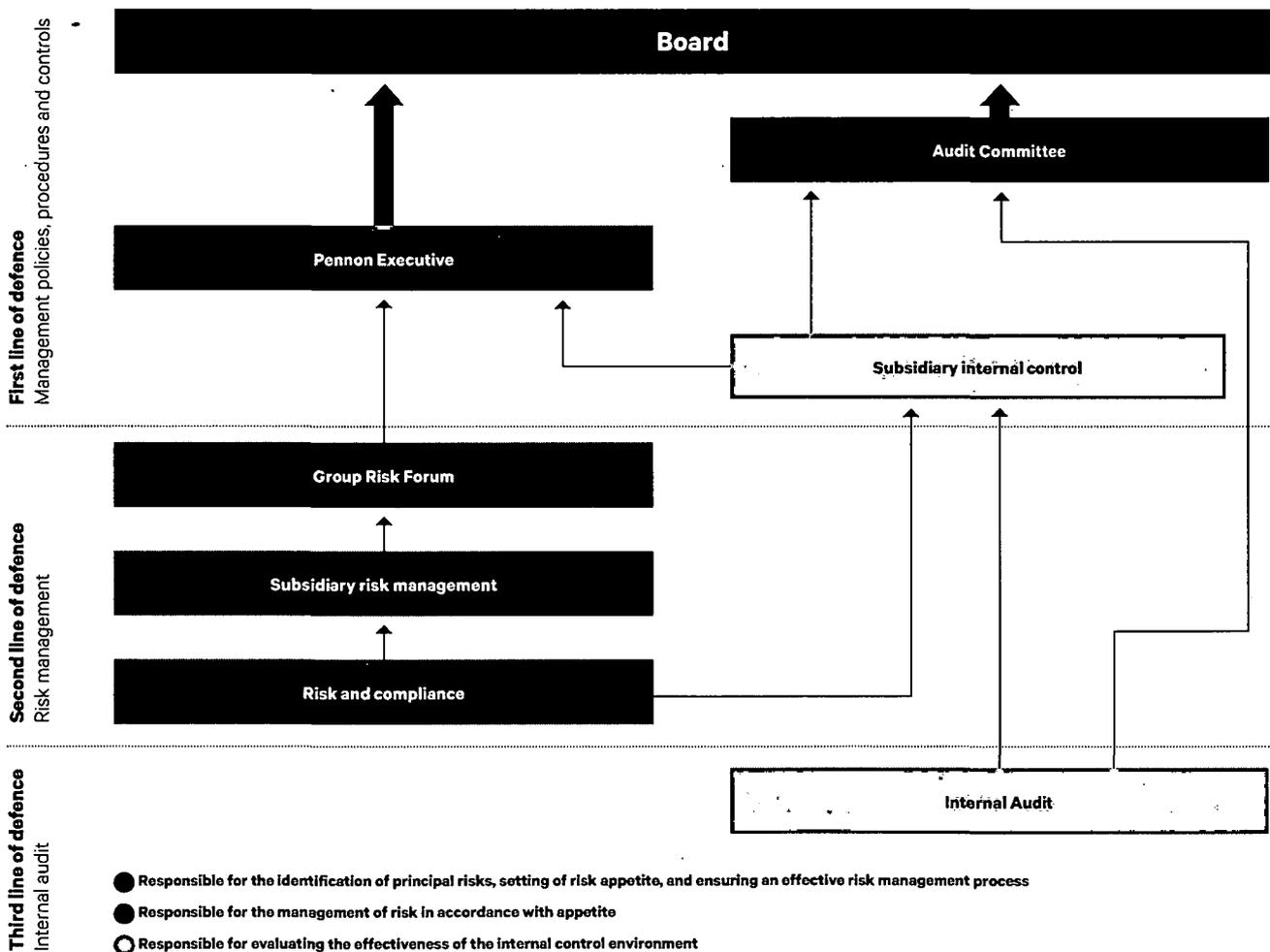
The Group faces a variety of risks which, should they arise, could materially impact its ability to achieve its strategic priorities. The effective management of these existing and emerging risks is, therefore, essential to the long-term success of the Group.

Pennon has a mature Group-wide integrated risk management framework (see diagram below) which is embedded into the existing governance structures and culture, and helps us to live up to our values of 'trusted' and 'responsible' in the way we carry out our business. Our risk management approach incorporates both top down and bottom up processes, ensuring a common understanding of the risks and opportunities that the Group is exposed to and how they may impact on the achievement of the strategic priorities.

A consistent Group-wide methodology is applied to the identification, evaluation and management of the Group's principal risks which considers both the likelihood of the risk occurring over a five-year period and the potential impact from a stakeholder and customer, financial, management effort and reputational perspective. Principal and other risks are captured in risk registers which are regularly reviewed and challenged.

The Group seeks to reduce its risk exposure, in line with the desired risk appetite and tolerance levels, through the operation of a robust internal control environment which is aligned to the three lines of defence model. The Board, via the Audit Committee, obtains comfort over the effectiveness of the internal control environment through the reporting of outcomes from a variety of internal and external assurance providers, including an independent internal audit function.

Risk management framework



The key elements of the Group's risk management process include:

	Key risk management responsibilities	Key assurance activities
First line of defence	Board <ul style="list-style-type: none"> • Sets the Group's strategic objectives • Establishes the Group's risk appetite • Determines the Group's principal risks • Ensures an effective internal control framework. 	<ul style="list-style-type: none"> • Quarterly reviews of the Group's principal risks against the determined risk appetite.
	Audit Committee <ul style="list-style-type: none"> • Reviews the effectiveness of the Group's risk management framework • Reviews the adequacy of the internal control framework. 	<ul style="list-style-type: none"> • Perform quarterly 'deep dive' reviews on principal risks • Approves the Group Internal Audit Plan • Receive reports on the outcomes of key assurance activities.
	Pennon Executive <ul style="list-style-type: none"> • Day-to-day management of the Group's principal and operational risks • Establishes the relevant Group-wide risk management processes and procedures • Maintaining the internal control framework. 	<ul style="list-style-type: none"> • Perform a thorough appraisal of the Group's risk profile quarterly • Monitoring of the Group's performance against KPIs and financial performance • Establishes and reviews policies, procedures and delegated authorities.
Second line of defence	Group Risk Forum <ul style="list-style-type: none"> • Provides review and challenge over subsidiary/functional principal risks and mitigation strategies • Alignment of the top down and bottom up risk management process • Horizon scanning on emerging risks and opportunities. 	<ul style="list-style-type: none"> • Quarterly review of Group and subsidiary principal risks on a quarterly basis • Deep dive reviews of specific risks. Topics include; cyber security, renationalisation, health and safety and financial markets and liquidity.
	Individuals subsidiaries/ functions <ul style="list-style-type: none"> • The identification and assessment of subsidiary level risks • Implementation and execution of appropriate risk mitigation strategies, aligned with the agreed risk appetite • Monitor compliance with internal control framework. 	<ul style="list-style-type: none"> • Review of subsidiary/functional principal risks on a quarterly basis by executive management teams • Risk and Compliance functions undertake compliance activities over ISO standards and other key business processes • Self-certification of compliance with internal control framework.
Third line of defence	Group Internal Audit <ul style="list-style-type: none"> • Provide independent, risk based assurance on the effectiveness of the internal control framework • Coordination of independent assurance activities. 	<ul style="list-style-type: none"> • Regular reporting to Audit Committee and Pennon Executive on the effectiveness of internal controls and the outcomes from other third line assurance activity.

Continuous improvement to risk management and internal control

The Group seeks to continually improve its approach to risk management and internal control. During the year there have been a number of developments which have further enhanced these processes, including:

- A director of Risk and Assurance has been appointed with responsibility for the Group Internal Audit and Risk Management functions and the coordination of assurance activities across the Group
- A Group-wide health and safety programme, HomeSafe, has been implemented across a number of sites and is being rolled out across the remainder of the Group
- The Group Health, Safety, Security and Assurance (HSSA) function will provide second line assurance over the application of HSSA processes and controls across the Group
- The Group has continued to align key corporate policies and procedures across all subsidiaries and functions
- Risks relating to Group corporate functions established during the year have been subject to review and challenge by the Group Risk Forum
- Viridor has successfully migrated to a Group shared services platform, providing greater consistency and control over key financial processes
- A new programme of legal and compliance awareness training for staff has been implemented.

Risk report continued

Risk appetite

The UK Corporate Governance Code requires companies to determine their risk appetite with respect to the level of risk it is considered appropriate to accept in achieving the Group's strategic priorities. Striking an appropriate balance between risk and reward is key to the success of the Group's strategy. The Board has established its risk appetite for each of the principal risks which allows the business to pursue value enhancing opportunities, while maintaining an overall level of risk exposure that the Board considers to be appropriate. The Board's evaluation of the effectiveness of internal control is considered in the context of the stated risk appetite.

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 Group's principal risks and uncertainties include those Group-level risks which 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 within the Group.

Principal risks and uncertainties

The Group's business model exposes the business to a variety of external and internal risks. The assessment of the Group's principal risks is informed by the potential impact of macro political, economic and environmental factors. While the ability of the Group to influence these macro level risks is limited, they continue to be regularly monitored and the potential implications on the Group are considered as part of the ongoing risk assessment process. This includes undertaking scenario planning and analysis to understand the risk exposure of one, or a number, of these events occurring and taking appropriate steps to reduce the potential impact.

Over the past year there has been a significant increase in the level of uncertainty within the water sector as a result of evolving political views on the future of the water industry and changes in the priorities and focus of Ofwat. Specific risks have been included within the statement of principal risks, on the following pages, which reflects this uncertainty and the potential risk exposure to the Group.

Additionally, the Group's tax related risk has evolved from *'uncertainly arising from open tax computations where liabilities remain to be agreed'* in the 2016 Annual Report to *'Tax compliance and contribution'*. This reflects both the finalisation of tax returns for older periods with HMRC and the increased external focus on the tax contribution of companies in the sector and other large corporate organisations.

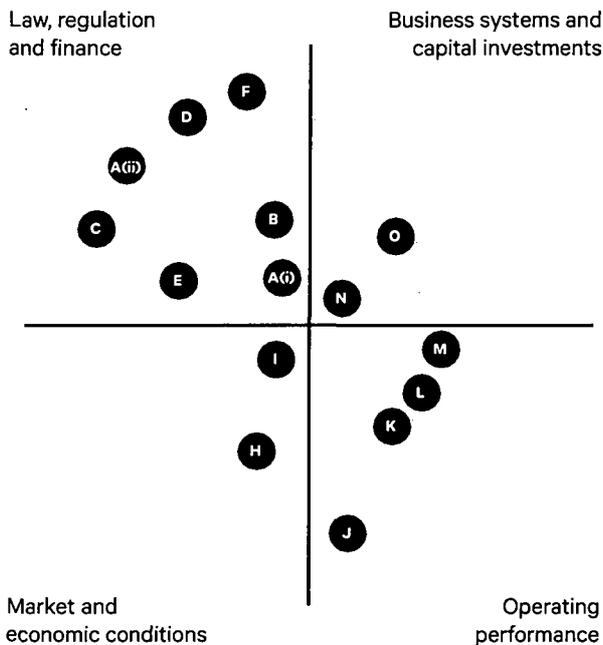
Britain's exit from the EU

The Group continues to regularly monitor the potential risks and implications arising from Britain's decision to trigger Article 50 and exit the EU. While a significant amount of uncertainty remains, the following issues have been identified which impact the Group's principal risks and may be influenced by any agreement between Britain and the EU:

- **Changes in environmental legislation, such as drinking and bathing water quality.** At present the Group does not anticipate any significant deviation in existing environmental legislation or regulations when existing EU legislation is transferred to domestic UK law (principal risk C)
- **Exposure to exchange rate and interest rate fluctuations.** There is limited exposure to exchange rate fluctuations which is further mitigated through the forward contracts providing certainty over future foreign currency risk. Interest rate risks are mitigated through the Group's long-term maturity of debt and finance leases with a significant proportion of interest-bearing liabilities at fixed rates (principal risk D)
- **Inability to access the same levels of funding from the European Investment Bank.** While the Group has a variety of funding opportunities available to it, it continues to call for an appropriate UK replacement (principal risk D)
- **Impact on the domestic economy and the ability of our customers to pay their bills.** The Group has mature processes to proactively monitor debt levels and operate a number of initiatives to support customers who are unable to pay their bills (principal risk H)
- **The ability to attract and employ EU nationals with the necessary skills and experience.** The Group faces continued challenges in attracting EU nationals as a result of the continued uncertainty over the movement of labour (principal risk M)

The Directors confirm that during 2017/18 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. These principal risks have been considered in preparing the viability statement on page 61.

Reporting an overview of the principal risk profile



Strategic impact

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

Long-term priorities affected.

Risk level



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.

Principal risks	Ref	Strategic priorities	Risk description	Not level risk	Trend
Law and regulation and finance	A	1, 2	Changes in Government policy: (i) Renationalisation	●	↔
			(ii) Use of single-use plastics	○	↔
	B	1, 2	Regulatory reform	●	↑
	C	1, 2	Compliance with laws and regulations	○	↔
	D	1, 3	Maintaining sufficient finance and funding to meet ongoing commitments	○	↔
	E	1, 2, 3	Non-compliance or occurrence of avoidable health and safety incident	●	↑
	F	2	Tax compliance and contribution	○	↔
Market and economic conditions	G	2	Increase in defined benefit pension scheme deficit	○	↔
	H	1, 2	Non-recovery of customer debt	●	↓
Operating performance	I	3	Macro-economic risks impacting commodity and power	●	↔
	J	1	Poor operating performance due to extreme weather or climate change	○	↑
	K	1, 3	Poor service and/or increased competition leading to loss of customers	●	↑
	L	1, 3	Business interruption or significant operational failures/incidents	●	↑
	M	1, 2, 3	Difficulty in recruitment, retention and development of skills	●	↑
Business systems and capital investments	N	1, 3	Failure or increased cost of capital projects/exposure to contract failures	●	↑
	O	1	Failure of IT system, management and protection including cyber risks	●	↑

Risk report
continued

Law, regulation and finance

Principal risk	Strategic impact	Mitigation	Not risk	Direction	Risk appetite
Changes in Government policy	<p>Long-term priorities affected: 1, 2</p> <p>Changes in Government policy may fundamentally impact our ability to deliver the Group's strategic priorities, impacting shareholder value.</p>	<p>(i) The renationalisation of the water industry continues to be a central policy of the Opposition and remains a possibility in the event of a change of Government. We recognise, however the existing Government is supportive of the existing regulatory model. We engage regularly with all political parties as well as customers and stakeholders demonstrating the value they receive based on our operational performance and continued investment in the network infrastructure.</p> <p>(ii) The Government is considering legislating on the use of specific single-use plastics to reduce the environmental impact and improve recycling rates. Viridor is well positioned to leverage this opportunity in the event that legislation is introduced and continue to invest in its sorting and reprocessing technology. Viridor is also a founding signatory to the UK Plastic Pact.</p>			<p>We recognise that Government policy evolves and seek to minimising potential risk and maximising opportunities through regular communication and robust scenario planning.</p>
Regulatory reform	<p>Long-term priorities affected: 1, 2</p> <p>Reform of the regulatory framework may result in changes to the Group's priorities and the service we provide to our customers. It may have a significant impact on our performance which can impact shareholder value.</p>	<p>During the year Ofwat finalised their price review methodology for 2020-25. There has also been a focus by the Government and Ofwat on the governance of companies in the water sector.</p> <p>We are well positioned for the new regulatory period with a dedicated, experienced PR19 project team, supported by external consultants, which is monitored through a robust governance framework.</p> <p>We are broadly supportive of Ofwat's proposed reforms and engage fully with the regulator during each consultation. South West Water already carries out its business in line with the improvements set out.</p>			<p>We accept that regulatory reform occurs and seek to leverage the opportunities this creates while mitigating the associated risk.</p>
Compliance with laws and regulations	<p>Long-term priorities affected: 1, 2</p> <p>The Group is required to comply with an ever increasing range of regulated and non-regulated laws and regulation across our water and waste businesses. Non-compliance with one or a number of these may result in financial penalties, a negative impact on our ability to operate effectively and reputational damage which could affect shareholder value.</p>	<p>Our robust regulatory framework ensures compliance with Ofwat, Environment Agency and other relevant requirements.</p> <p>Employees, contractors and partners receive a rolling programme of training and guidance. Additionally, during the year we have launched our 'Speak Up' whistleblowing policy.</p> <p>We have been proactive in reviewing our policies and processes in preparation for the introduction of the General Data Protection Regulation and have appointed a dedicated Data Protection Officer.</p>			<p>The Group has the highest standards of compliance and has no appetite for legal or regulatory breaches.</p> <p>We aim to minimise the impact of regulatory reform by targeting changes which are NPV neutral over the longer term to protect customer affordability and shareholder value.</p>

Law, regulation and finance continued

Principal risk	Strategic Impact	Mitigation	Net risk	Direction	Risk appetite
Maintaining sufficient finance and funding, within our debt covenants, to meet ongoing commitments	<p>Long-term priorities affected: 1, 3</p> <p>Failure to maintain funding requirements could lead to additional finance costs and put our growth agenda at risk. Breach of covenants could result in the requirement to repay certain debt.</p>	<p>The Group have mature treasury, funding and cash flow policies in place. We regularly consider how political, economic and regulatory risks may impact on the Group's financing commitments and cashflow.</p> <p>The Group operates with strong liquidity position and diversified funding mix. South West Water is funded to March 2020 while the Viridor committed energy recovery facility (ERF) programme is also fully funded.</p> <p>The successful refinancing of the £300 million hybrid in September 2017 has also strengthened our investment capacity and covenant position.</p>			We operate a prudent approach to our financing strategy in order to ensure our funding requirements are fully met.
Non-compliance or occurrence of avoidable health and safety incident	<p>Long-term priorities affected: 1, 2, 3</p> <p>A breach of health and safety law could lead to financial penalties, significant legal costs and damage to the Group's reputation.</p>	<p>The effective management of health and safety related risks continue to be a priority for the Board and Pennon Executive.</p> <p>The HomeSafe programme was successfully piloted in Viridor's materials recycling facility site in Plymouth, nationwide rollout commenced in April 2018. This is supported by a programme of capital investment for existing assets.</p> <p>The Group has also invested in people, processes and systems within its HSSA function during the year which will assist in driving consistency and monitoring compliance with the Group's health and safety standards.</p>			The Group has no appetite for health and safety related incidents and has the highest standards of compliance within the Group and third parties.

Risk report
continued

Market and economic conditions

Principal risk	Strategic impact	Mitigation	Net risk	Direction	Risk appetite
Non-recovery of customer debt	<p>Long-term priorities affected: 1, 2</p> <p>Potential impact on revenue as a result of reduced customer debt collection, particularly with regards to vulnerable customers and affordability.</p>	<p>Mature and embedded debt collection strategies are in place for the recovery of South West Water domestic customer debt. This is supplemented by affordability tariffs such as Restart, WaterCare and Freshstart to help reduce our bad debt exposure for those customers who are struggling to pay. Within the non-household market there has been renewed focus on the collection of older debt which has proved effective.</p> <p>Due to high proportion of public sector contracts, Viridor's debt collection risk is lower, however, customer debt is regularly reviewed and proactively managed.</p>	●	↓	While seeking to minimise non-recoverable debt, we recognise customer affordability challenges and the inability to disconnect domestic customers, some risk of uncollectable debt remains.
Macroeconomic risks arising from a downturn in the global and UK economy and commodity and power prices	<p>Long-term priorities affected: 3</p> <p>Challenges such as continued local authority, reduced global demand for our recycled commodities and decreases in power prices have a direct impact on the revenues generated by our recycling business.</p>	<p>We work closely in partnership with our local authority customers in the delivery of our services, while Viridor remains well positioned across the waste hierarchy, with long term contracts supporting the ERF segment.</p> <p>We have secured new markets for our paper and plastic recycle in response to changes in quality requirements announced by China. We continue to invest in our assets and are working with our supply chain to improve the quality of paper recycling, we are also implementing self-help measures to drive operational efficiencies.</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>	●	↔	We seek to take well-judged and informed decisions while ensuring plans are in place to mitigate the potential impact of macroeconomic risks.

Operating performance

Principal risk	Strategic impact	Mitigation	Not 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 being incurred and reputational damage.</p>	<p>Contingency plans, emergency resources and investment through a planned capital programme assist in mitigating this risk. Extreme weather conditions, such as those experienced in March 2018, are expected to test the resilience of South West Water's assets, while the expectations of both customers and Ofwat with regards to operational performance during such an event have increased.</p> <p>We also prepare drought plans every three years which are reviewed annually for a range of climate change and demand scenarios. The recently published Water Resources Management Plan has not identified an overall significant increase in the risk to water resources, however ongoing climate change will continue to challenge this.</p> <p>Viridor has in place a regional adverse weather management strategy, aimed at reducing disruption to site operations and transport logistics.</p>	●	↑	We seek to reduce both the likelihood and impact through long-term planning to ensure sufficient measures are in place.
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 the ability of both Viridor and Pennon Water Services to retain and grow market share.</p>	<p>Targeted improvements have been made to continually improve customer service within South West Water has contributed to the achievement of the ServiceMark accreditation during the year and we continue to secure high service incentive mechanism (SIM) scores.</p> <p>There has been a significant focus within Viridor on our customer experience during the year and the reorganisation of the marketing and sales, service delivery and customer service functions has improved this further, alongside the launch of an annual customer survey.</p> <p>Both Viridor and Pennon Water Services have a large and diverse customer base and are not materially exposed to the loss of any one customer.</p>	●	↑	We continually seek to increase customer satisfaction and maximise customer retention while taking well-informed risk to develop further markets.
Business Interruption or significant operational failure/incidents	<p>Long-term priorities affected:</p> <p>1, 3</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 the successful delivery of the PR14 business plan.</p> <p>Additionally, business interruption caused by defects, outage or fire could impact the availability and optimisation of our ERFs and recycling facilities.</p>	<p>A continued reduction in the number of pollution events in wastewater has been identified as a priority and a programme of targeted action is currently underway to address these risks.</p> <p>Both South West Water and Viridor maintain detailed contingency plans and incident management procedures which are regularly reviewed. Equipment failure is managed through a programme of sophisticated planned and preventive maintenance regime and effective management of stores. The focus on the effective optimisation of ERFs in particular has resulted in availability exceeding the Group's original forecasts.</p> <p>The Group also maintains comprehensive insurance across its asset base in the event of an incident occurring.</p>	●	↑	We operate a low tolerance for significant operational failure or incidents and seek to mitigate these risks where possible.

Risk report
continued

Operating performance continued

Principal risk	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: 1, 2, 3</p> <p>Failure to have a workforce of skilled and motivated individuals will detrimentally impact all of our strategic priorities. We need the right people in the right places to share best practice, deliver synergies and move the Group forward in the new shared services structure.</p>	<p>The people strategy, underpinned by six threads, has been rolled out across the Group and is designed to ensure we have the workforce necessary to deliver our strategic priorities. This has included our refreshed Vision, increased workforce engagement, continued commitment to training and development and the introduction of a Pennon Code of Conduct.</p> <p>Succession plans remain in place for senior and other key positions. Challenges remain, however, in sourcing skills and expertise externally for specific senior and operational roles with the implications of Brexit continuing to add additional uncertainty.</p>			While turnover does occur, we ensure the appropriate skills and experience is in place with succession plans to provide resilience in mitigating the impact of this.

Business systems and capital investment

Principal risk	Strategic impact	Mitigation	Net risk	Direction	Risk appetite
Failure or increased cost of capital projects/exposure to contract failures	<p>Long-term priorities affected: 1, 3</p> <p>Inability to successfully deliver our capital programme may result in increased costs and delays and detrimentally impacts our ability to provide top class customer service and achieve our growth agenda.</p>	<p>All capital projects are subject to a robust business case process and skilled project management resource and senior oversight is utilised to provide additional rigour in the delivery of major projects.</p> <p>Robust due diligence is undertaken on key suppliers, technologies and acquisitions. Back to back agreements and supplier guarantees also provide additional protection.</p> <p>Commissioning at Beddington, Dunbar and Glasgow Recycling and Renewable Energy Facility (GRREC) continued through the year, with financial contributions from Dunbar ERF protected by contractual mechanisms. Expenditure at GRREC is above initial expectations. Viridor is contractually entitled to recover incremental costs under certain circumstances.</p> <p>Avonmouth ERF and Mayflower water treatment works remain on schedule and on budget.</p>			Pennon's investment activities are taken on an informed basis with risks weighed against appropriate returns.
Failure of information technology systems, management and protection including cyber risks	<p>Long-term priorities affected: 1</p> <p>Failure of our information technology systems, due to inadequate internal processes or external cyber threats could result in the business being unable to operate effectively and the corruption or loss of data. This would have a detrimental impact on our customers and result in financial penalties and reputational damage for the Group.</p>	<p>The Group operates a mature and embedded governance framework over the business as usual IT environment and major project implementations. This is aligned to ISO27001 standards and regular internal and external assessments are undertaken to maintain this accreditation. Disaster recovery plans are in place for corporate and operational technology and these are regularly reviewed and tested.</p> <p>Cyber risks are mitigated by a strong information security framework. This is aligned with guidance issued by the National Cyber Security Centre (NCSC). Awareness campaigns have been undertaken during the year aligned with preparations for GDPR. A variety of internal and external assessments are also undertaken, including annual penetration testing, to test the robustness of our controls.</p>			We seek to minimise the risk of informational technology failure and cyber security threats to the lowest level without detrimentally impacting on business operations

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 56 to 60 of the risk report. The Group's principal operating subsidiaries of South West Water and Viridor are long term business characterised by multi-year investment programmes, with associated revenue streams

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 and other 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 resilience	Ability to manage external shocks or potential market dislocations that could impact on financing strategy
Group recruitment and retention	Review of people risks including the ability to attract and retain the right skills to deliver the Group strategy
Water resources and resilience	Consider the impact of climate change and drought risks on water resources and ongoing flood-related resilience

In stress testing the Group's business plan it was determined that none of the individual principal risks would in isolation, or in aggregate, compromise the Group's viability. In performing this stress testing all risks have been monetised with reference to risk weighting, factoring in the likelihood of occurrence and financial impact. In addition, further factors were considered to reverse engineer a scenario that could possibly compromise the Group's viability, these included:

- All the principal risks occurring in all of the five years
- Lower RPI projections in each of the five years
- Significant one-off costs
- A deterioration in the credit quality of amounts owed to the Group.

The three factors above, which are in addition to the principal risks, have been monetised as absolute financial costs and are not risk weighted on likelihood of occurrence.

The Board considered the monetary impact of these factors on the Group's viability over a five-year period, concluding the reversed engineered scenario remote. The five-year period was chosen given the longer-term nature of the Group's businesses.

As part of the Board's considerations, additional scenarios concerning South West Water Limited's viability were reviewed. This additional assessment considered South West Water's regulatory financial ring fence through the following scenarios that are recommended to be tested by Ofwat:

- Totex underperformance (15% of totex)
- ODI penalty (3% of RoRE) in one year
- Inflation sensitivities (+/-3%)

- Increase in the level of bad debt (20%)
- New debt financed at 2% above forward projections
- Financial penalty – equivalent to 3% of turnover
- Any relevant inter-company financing scenarios.

These scenarios were considered in isolation and in the following combination

- 10% totex underperformance in each of the five years
- ODI penalty of 1.5% in each of the five years
- A one-off financial penalty of 1% of revenue.

The Directors concluded these scenarios in isolation and the combination noted above did not compromise the viability of South West Water or the Group over the five-year assessment period.

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 75, 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 61, 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 61 was approved by the Board on 24 May 2018.

By Order of the Board

HPBHague

Helen Barrett-Hague

Group General Counsel and Company Secretary
24 May 2018

**We are committed to
the highest standards
of corporate governance**

**GOVERNANCE AND
REMUNERATION**

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Chairman's letter to shareholders

“ We are committed to carrying out our business in a responsible way for the benefit of all our stakeholders. ”

Sir John Parker
Chairman

Dear Shareholder

I am pleased to introduce the corporate governance report for 2018 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.

At Pennon we consider that strong governance is central to our successful management of the Group. 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 third year as Chairman of Pennon, I remain committed to ensuring that we continue to operate to the highest standards of corporate governance.

Additional complexity is added to Pennon's governance structure as a result of our ownership of a regulated water and wastewater business, South West Water, alongside our non-regulated businesses. In order to comply with the requirements of Ofwat, South West Water is required to have its own independent board of directors and to operate as if it were a publicly listed company in its own right.

We consider that our board and committee framework has enabled us successfully to streamline our decision-making processes such that we avoid duplication. The South West Water board, which includes all of the Pennon Non-Executive Directors, as well as three South West Water only non-executive directors, convenes before each Pennon Board meeting and considers South West Water strategy, performance and regulatory planning. In its meetings the Pennon Board concentrates on strategic forward-looking matters for all parts of the Group, as well as overseeing the Viridor businesses.

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 stakeholders.

It is my view that the Board is highly effective with a good understanding of the Group's opportunities for growth as well as the threats facing the business. This view is supported by the results of this year's Board and Committee performance evaluations. Further details are provided on page 71 and 72.

Stakeholder engagement

The Board understands the part the Group can play in bringing resources to life and creating a more sustainable UK. We are committed to carrying out our business in a responsible way and remain focused on improving the provision of water and waste services for benefit of all of our stakeholders.

We actively engage with our customers, our communities, our people and our suppliers, as well as with our investors, and maintain appropriate and regular dialogue with those stakeholders to ensure that the rationale for our strategy and our performance objectives reflects their expectations. It also allows stakeholders to provide feedback on the matters they consider to be important and any issues which require addressing.

Further information about the stakeholder engagement mechanisms we use to gather feedback is available on our website.

 **READ MORE ONLINE**
www.pennon-group.co.uk/sustainability

Our shareholders are a key stakeholder group and we have a comprehensive investor relations programme. During the year some 81 meetings and conference calls were held. Pennon attended eight city conferences and sales force briefings and six road shows, including in the USA 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.

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.

It is always pleasing to be part of a well-attended AGM and I welcome questions on any business issues affecting the Group. At our 2018 AGM on 5 July, all of our Directors intend to be present together with a number of other senior executives of our businesses to meet shareholders and 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 April 2016 version of the Code, which is effective for reporting periods commencing on or after 17 June 2016.

Beddington energy
recovery facility

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 105 the Board confirms to shareholders that the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the information necessary to assess the Company's performance, business model and strategy.



Sir John Parker
Chairman

Pennon Group plc
24 May 2018

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 is widely recognised for his policy work on the value of diversity in the boardroom, having chaired the Government's review on Ethnic Diversity on UK Boards in 2017. Prior to that, he was a member of the Davies Committee – Women on Boards.

He has chaired five FTSE 100 companies and was previously the chairman of Anglo American plc (until October 2017) and 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 and is a Visiting Fellow of the University of Oxford.

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 construction and engineering company Laing O'Rourke and of Advanced Plasma Power Limited. He is also a non-executive director of Carnival Corporation and Airbus Group. He is a senior adviser to Spencer Stuart and is the senior non-executive director on the Cabinet Office board.

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

Board Committee members

- Pennon Executive
- Audit Committee
- Sustainability Committee
- Nomination Committee
- Remuneration Committee
- △ Chair of Committee

Gill Rider ●▲○○

Senior Independent Director (Non-Executive)

CB, PhD, CCIPO

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

During the year, Martin was 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. He is currently the chief financial officer of Currencies Direct, a foreign exchange broker and international payment provider. Previously, 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

Executive Director, Currencies Direct.

Helen Barrett-Hague

Group General Counsel and 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 holding positions of increasing responsibility with PA Consulting, 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.

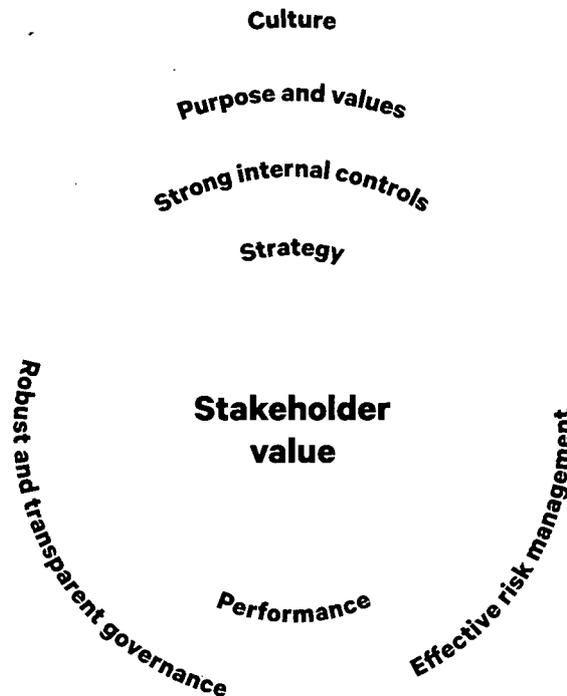
External appointments

None.

The Board and its governance framework

The Board acts as the main governing body for the purpose of oversight for the Group with additional supervision of the regulated business of South West Water being provided by South West Water's own board. Our approach to governance is an integral part of our culture, guiding how we do business and create value for our stakeholders.

 READ MORE ON PAGES 14 & 15



Stakeholder value

We deliver sustainable value for our stakeholders by providing high-quality environmental infrastructure and customer services.

Strategy

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

Performance

Our financial and operational performance is driven by our strategic sustainability objectives.

Robust and transparent governance

We are committed to operating to the highest standards of corporate governance.

Effective risk management

We have a mature integrated risk management framework which is embedded into existing governance structures and ways of working.

Strong internal controls

We keep the effectiveness of our internal control environment under regular review and seek continually to improve our approach.

Vision and values

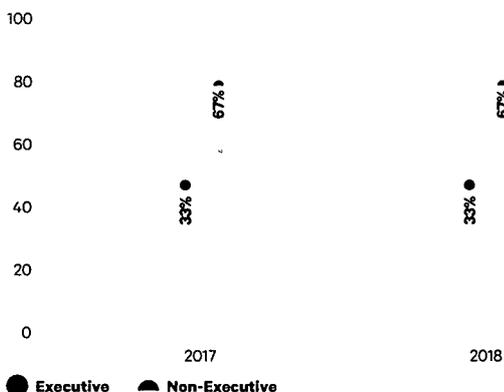
Our Vision of 'Bringing resources to life' and supporting values of 'trusted, responsible, collaborative and progressive' will help drive our strategic priorities over the long term.

Culture

We are developing a culture that can be lived throughout the Group with integrity and transparency, ensuring Pennon is trusted and valued by all its stakeholders.

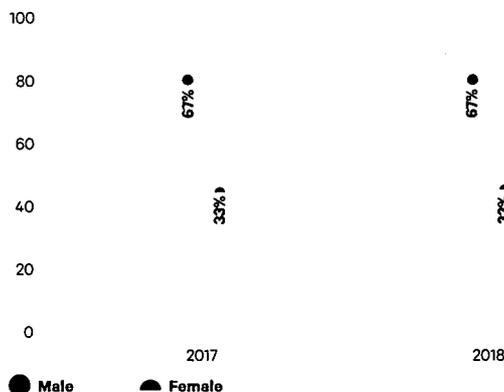
Pennon Board composition, independence and experience

Composition as at 31 March



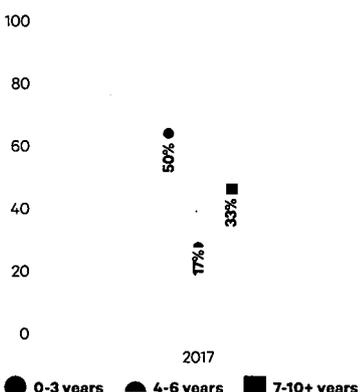
At the end of the year the Board of Directors comprised the Chairman, two Executive Directors and three Non-Executive Directors.

Diversity as at 31 March



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

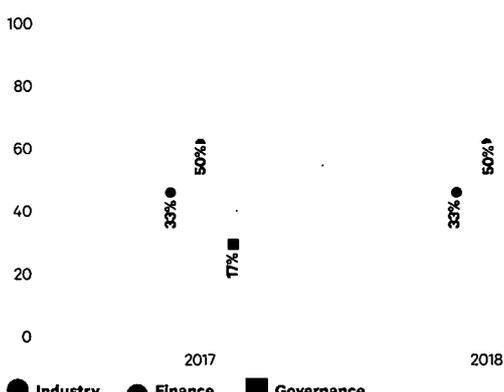


All of the Non-Executive Directors were considered by the Board to be independent throughout the year. None of the relationships or circumstances set out in provision B.1.1 of the UK Corporate Governance Code (the UK Code) applied to the Non-Executive Directors listed on the following page. Given the longer service of Martin Angle and Gill Rider on the Board, a particularly rigorous review was undertaken in respect of their respective re-elections. Martin Angle will be stepping down from the Board in December 2018 in order to allow for continuity with a replacement. Gill Rider will soon reach the six-year anniversary of her appointment and the Board has agreed that her term be extended for a further three years, subject to annual re-election at each AGM. The Board is satisfied that, based on their participation at meetings and their contribution outside of the boardroom, both Martin Angle and Gill Rider continue to demonstrate independence of character and judgement in the performance of their role.

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 overall 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.

Experience as at 31 March



All 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 66 and 67 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 67).

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 Managing investor relations including financing and treasury activities
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.

Board meetings and attendance

The Directors and their attendance at the nine scheduled meetings of the Board during 2017/18 are shown below:

Members	Appointment date	Attendance
Chairman		
Sir John Parker	April 2015	9/9
Non-Executive Directors		
Martin Angle	December 2008	8/9
Neil Cooper	September 2014	9/9
Gill Rider	September 2012	9/9
Executive Directors		
Susan Davy	February 2015	9/9
Christopher Loughlin	August 2006	9/9

In addition to the nine Board meetings we hold a strategy day in September of each year.

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 the Group's 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.

Detailed consideration of certain matters is delegated to Board Committees, to the Executive Directors and to the Group General Counsel and 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 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. The Board also receives presentations on key areas of the business and undertakes site visits to meet employees and gain a better understanding of the operation of business initiatives.

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 whilst protecting the interests of the wider stakeholder group.

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

Q Board visit to Plymouth sites

In February 2018 the Board visited two sites in Plymouth; South West Water's innovative Mayflower water treatment works, which is due to become operational this autumn, and Viridor's materials recycling facility, the location of the first pilot for our new health and safety programme, HomeSafe. Further details on each of these projects are provided on pages 39 and 26.

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.

In arriving at decisions the Board takes into account the impact on stakeholder groups when considering what is in the best interests of shareholders as a whole.

Pennon Board composition

Chairman	Group CEO	CFO
Three independent Non-Executive Directors of Pennon	In attendance	Three independent non-executive directors of South West Water

Board support and training

Directors have access to the advice and services of the Group 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 meet with staff to receive briefings on key processes and systems.

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

Performance evaluation

The Board undertakes a formal and rigorous review of its performance and that of its Committees and Directors each year. Having carried out an externally facilitated evaluation last year, this year, the evaluation of the Board's and the Committees' performance was carried out in March 2018 by means of a questionnaire created internally by the Group General Counsel and Company Secretary in consultation with the Chairman and Chairs of the various committees. As well as the Directors, the questionnaire was completed by various members of the senior executive team, the external audit partner and the adviser to the Remuneration Committee.

The questions were designed to assess the effectiveness of the Board during the year in setting the Group's strategy, promoting Pennon's culture and values, ensuring that the Group's obligations to its shareholders and other stakeholders were understood and met, overseeing the use of the Group's resources, managing the risks inherent in the strategy, plans and the operating environment, and ensuring that the executive team had managed all the activities of the Company well.

The Board and its governance framework continued

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 and that the Board had a good understanding of opportunities for growth and the threats facing the business, as well as its role in setting Pennon's values and standards to ensure that its obligations to its stakeholders are met. The Board's commitment to promoting a strong health and safety culture across the Group was noted. The Board and each Committee considered the conclusions and recommendations arising from the evaluation process, which included areas specifically relating to diversity and succession planning, as well as continuing to address the Directors' training and development needs.

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 73 to 83 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.

 **READ MORE ONLINE**
www.pennon-group.co.uk/about-us/board-committees

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 2017/18 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 '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's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting, which brings together elements of best practice for risk management and internal control by companies. The Board's risk framework described on pages 52 to 54 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. ESG risks identified and assessed by the Board cover areas such as health and safety, climate change, changes to government policy on waste and recycling, and tax compliance. Details of the key risks affecting the Group are set out in the strategic report on pages 55 to 60. KPIs are in place to enable the Board to measure the Company's ESG performance (pages 24, 25 and 28 to 40) and a number of these are linked to remuneration incentives (pages 91, 93 and 94).

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'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 55 to 60.

Code of Conduct and policies

The Group's Code of Conduct and related policies set out Pennon's commitment to promoting and maintaining the highest level of ethical standards. Areas covered include our impact on the environment and our communities, our workplace and our business conduct.

The Group's policy on anti-bribery and anti-corruption clearly prohibits any worker from offering or accepting bribes, facilitation payments and kickbacks and requires that due diligence checks be carried out before engaging a third party (including a corruption risk assessment including potential business partners of the third party and the nature of the proposed work and transaction). The policy also sets out the employment consequences for breach of the policy and potential legal sanctions under bribery laws. The policy places an obligation on workers to report any breach of the policy or any suspicions of fraud or other irregularities. The Group's whistleblowing policy ('Speak Up') encourages workers to raise concerns and explains how this should be done.

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.

Our Code of Conduct and our policies are available on our website.

 **READ MORE ONLINE**
www.pennon-group.co.uk/sustainability

Board Committees' reports

Audit Committee report

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

Neil Cooper
Audit Committee Chairman

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 that includes the testing of accounting judgements made in preparing financial reporting and the assessment of 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 and adequacy of risk management processes across the Group. This includes monitoring the Group's risk appetite as well as acting as a forum for carrying 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 a further 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.

The Group's executive risk management forum continues to assess risk appetite and monitor key risks and their mitigation, with the Committee subsequently receiving detailed 'deep dive' presentations from senior management on individual principal risks. During the year, these included Group recruitment and retention risk, water resources and resilience risk, cyber security, and lastly financial resilience. More detail on our risk management processes, principal risks and their associated mitigation can be found on pages 52 to 60.

Together with this, we continue to assess the Company's viability over a period of five years, which we judge to be aligned with the longer-term nature of our business. It is also a reasonable period 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 61.

The Committee acts as a forum carrying out more detailed reviews of higher-risk areas of the operation.

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 75. 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.

Finally, our long-serving Group Internal Audit Manager, Paul Ramsbottom, stepped down during the year, and I would like to thank him on behalf of the Committee for his service to the Group.

Neil Cooper
Audit Committee Chairman

Audit Committee report

continued

Audit Committee composition and meetings

	Date of appointment to Pennon Audit Committee	Attendance
Committee chairman		
Neil Cooper	September 2014	4/4
Committee members		
Martin Angle	December 2008	4/4
Gill Rider	September 2012	4/4

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; Director of Treasury, Tax and Group Finance; Group Audit Manager; and the 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 71.1R 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 66 and 67.

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 Review of internal audit reports on core systems and processes across the Group, for example, contract management, health and safety and an outsourced audit of Group Treasury Reviewed our Tax Strategy prior to publication in line with the requirements set out in the Finance Act 2016 Monitored the effectiveness of key strategic projects, including Viridor's Enterprise transformation and readiness for the new EU General Data Protection Regulations
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 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 Reviewed the Group external audit policy and monitored the provision of non-audit services Considered the auditor's report on control themes and observations for the year ended 2017, which did not identify any significant deficiencies
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 which through 2017/18 has been aligned to the Group's financial 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	<ul style="list-style-type: none"> Discussed the results of the performance evaluation of the Committee Reviewed new annual report disclosure requirements, including the audit report Considered and approved Group accounting policies, including the impact of new accounting standards, used in the preparation of the financial statements 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 2018 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, together

with the areas of particular audit focus, as reported on in the independent auditor's report on pages 108 to 113. In addition to the significant matters set out in the table below, the Committee considered a range of other matters. These included presentational matters, in particular relating to the issuance and buy-back of perpetual capital securities, contingent liabilities and assets, the non-underlying disclosures and finally ensuring a fair presentation of statutory and non-statutory performance and financial measures.

During the year, the Committee's areas of focus have been:

Area of focus	How the matter was addressed by the Committee
Revenue recognition	Given the nature of the Group's business, 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, in particular for Glasgow Recycling and Renewable Energy Centre, where forecast construction spend has increased, 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 as compared to 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 Environmental provisions	<p>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 and management's review of evidence of indicators for potential impairment of non-current assets concluded that these areas were less sensitive to assumptions.</p> <p>Following a detailed review of the analysis undertaken, and consideration of management assumptions in relation to the value of environmental provisions the Committee was satisfied that a robust and consistent approach had been followed and with management's assertion that the carrying value of these liabilities remained reasonable, and therefore the Committee was able to approve the disclosures in the financial statements.</p> <p>This key area was also closely reviewed as part of the year-end audit by the external auditor.</p>
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 both 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.
Greater Manchester contract reset	Following the renegotiation of the Greater Manchester contract and sale of the joint venture Viridor Laing (Greater Manchester) Holdings Limited to the Greater Manchester Waste Disposal Authority, judgement has been required to ensure all the various economic aspects of the reset have been fully considered in concluding the appropriate accounting treatment. In particular consideration was given to the fair value attributed to all aspects of the transaction in arriving at the amount of profit to be recognised at our TPSCo joint venture. The Committee has received detailed analysis from management in satisfying itself that this treatment is appropriate. In addition this has been a significant area of focus for the external auditor.
Glasgow Recycling and Renewable Energy Centre (GRREC) – outstanding contractual claims against Interserve	In November 2016 the lead construction contract for the GRREC was terminated due to delays and underperformance. Additional costs required to complete the project have been incurred and are now subject to claims including against the lead contractor, Interserve Construction Limited. The Committee has reviewed information on the background, quantum and likelihood of the claims recognised in accounting terms as an amount owing to the Group, considering both legal and financial analysis from management and expert third party opinions. The Committee is satisfied that the asset recognition criteria for this amount has been met and that appropriate disclosures have been made.
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 estimates 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 enable the Committee to better 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 of either the annual report or half-year results. The Committee 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 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 61.

Audit Committee report continued

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 FRC's Ethical Standard 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 2017 Annual General Meeting. Debbie O'Hanlon is the audit partner and has been in that role since Ernst & Young's appointment. 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. Further details of the performance evaluation are provided on pages 71 and 72. No issues were raised during that review and the Committee concluded that the auditor was effective during the year.

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 FRC's Ethical Standard 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 typically relate to agreed procedures in relation to annual regulatory reporting obligations to Ofwat; work which is 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 and for the Committee chairman to approve all non-audit work performed by the statutory auditor. 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 were another accounting firm that could provide the required cost-effective 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 31.63% 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 131.

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 which makes a significant contribution to the ability of the Committee to deliver its responsibilities.

A new Group internal audit plan was approved in January 2018, which aligns the annual internal audit programme with the Group's financial year. It takes account of the principal risks, the activities to be undertaken by the external auditor, and 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.

As in previous years, the Group Internal Audit Manager reported regularly to the Committee on audit reviews undertaken and their findings, and there were regular discussions, correspondence and private meetings between the Group Internal Audit Manager and the Committee chairman. During the year, the long-serving Group Internal Audit Manager stepped down. This presented a logical opportunity for the Group to review its organisation structure in this area. As a result, since the year end, a new senior management position of director of Risk and Assurance has been created, with specific responsibilities for keeping the Committee informed of internal audit activities.

An external assessment of the internal function that was performed by KPMG LLP in 2016 concluded that the Company's internal audit function conforms to IIA standards issued by the Institute of Internal Auditors but identified some areas for improvement including the alignment of the internal audit annual programme with the financial year and refreshed reporting content. These have been actioned.

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 105, 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 108 to 113.

In preparing and finalising the 2018 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 the Pennon Executive. 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.

Sustainability Committee report

“ Our sustainability objectives are an essential part of our long-term strategy and create value for all our stakeholders. **”**

Gill Rider

Sustainability Committee Chairman

Dear Shareholder

I am pleased to introduce the Sustainability Committee's report on its activities during the year. Sustainability remains an important and 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 set and oversee the delivery of Pennon's sustainability objectives, which our Chief Executive Officer sets out on page 22. We do this by bringing together and reviewing initiatives that drive sustainability, approving targets and monitoring the progress made in achieving them. Our sustainability objectives are truly 'strategic' in that they are an essential part of our overall long-term strategy and create value for all our stakeholders. On pages 14 to 17 we explain the relationship between our strategy, sustainability objectives, the measurement of performance and how we reward our Executive Directors. All of this is underpinned by our corporate values, as Pennon strives to be trusted, responsible, collaborative and progressive.

Through delivery of our sustainability objectives, we are able to uphold the highest standards of corporate responsibility for the benefit of all our stakeholders – our customers, our communities, our people and our suppliers, and our investors. The Committee has always played a central role in promoting and safeguarding stakeholder interests and is pleased to see that stakeholder engagement is now recognised as an essential aspect of corporate governance. Pennon and its subsidiaries have always taken a proactive and comprehensive approach to stakeholder engagement and we continue to monitor and refine the mechanisms we have in place to support continuing dialogue. More information on our approach to stakeholder engagement is provided on page 64.

Throughout this annual report we show how a thorough approach to sustainability helps us to draw together the needs of society with the delivery of commercial success. We are pleased to note the results achieved throughout the Group, which confirm sustainability is indeed integrated in all we do.

Gill Rider

Sustainability Committee Chairman

Sustainability Committee report continued

Sustainability Committee composition and meetings

	Date of appointment to Pennon Sustainability Committee	Attendance
Committee chairman		
Gill Rider	September 2012	4/4
Committee members		
Martin Angle	December 2008	4/4
Susan Davy	March 2018	1/1
Chris Loughlin	November 2006	4/4

Susan Davy joined the Committee in March 2018. Her involvement reflects the growing and welcome interest of our investors in environmental, social and governance (ESG) matters and the relevance of ESG to Pennon's funding strategy and financial decision-making.

The Sustainability Committee sets a range of targets for the Group's subsidiaries as part of their business planning processes. Progress against these targets is reported to the Committee throughout the year. In addition, the South West Water sustainability committee continues to provide oversight of South West Water's performance against its sustainability targets 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 regulated business.

We aim to set stretching targets and as at 31 March 2018 South West Water had achieved six of its 12 targets for the year, and Viridor had also completed six out of 12 of its targets. Full details of the sustainability targets for South West Water and Viridor for 2017/18, and their performance against them, are given in their respective reports.

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.

The Sustainability Committee balances the requirement to conduct business in a responsible manner (in relation to 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 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 the first Group-wide employee engagement survey
- the new Group HR strategy, 'Talented people doing great things for our customers and each other'
- sustainable procurement and practices within the supply chain
- sustainability reporting for 2017 and the associated verifier's reports and recommendations
- progress against the sustainability targets for 2017/18 and sustainability targets for 2018/19.

In addition, the Committee considered:

- the results of the Group's gender pay gap analysis and proposed action plan
- the implementation of a Group-wide compliance and ethics training programme
- recommendations arising from the first Group submission to BitC's Corporate Responsibility Index
- a strategic review of Pennon's approach to ESG reporting and disclosure, to support potential "green" funding initiatives.

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 the Group'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 Jacobs.

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)
- Review of the Chief Executive Officer (page 20)
- Key performance indicators (page 24)
- Our people (page 26)
- Our operations (pages 28 to 41).

South West Water and Viridor sustainability reports

The sustainability report for Viridor will be published in August 2018, and South West Water will incorporate its sustainability reporting in its company annual performance report and regulatory accounts, which will be published in July 2018. Both documents will be available to view at www.pennon-group.co.uk and also on the subsidiaries' websites.

Nomination Committee report

“ Action is being taken to encourage the growth of a diverse workforce where individuals from different backgrounds can fulfil their potential. ”

Sir John Parker
Nomination Committee Chairman

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

Matters considered by the Committee during the year included:

- A revised policy on Diversity, Respect and Inclusion
- The Group's performance against its diversity and equality policies
- The recruitment and appointment of Jon Butterworth as a non-executive director of South West Water, to fill the vacancy arising from the resignation of Steve Johnson in April 2016
- The extension of Neil Cooper's term of office as a Non-Executive Director of Pennon Group plc for a second term of three years commencing on 1 September 2017 and expiring on 31 August 2020
- The confirmation of Adele Barker's appointment as Group director of Human Resources, a role which she had held on an interim basis during the recruitment process
- The appointment of Ed Mitchell as 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
- A review of our gender pay disclosure and ongoing action plan
- The structure, size and composition of the Board, including the skills, knowledge, independence, diversity and experience of the Directors
- A review of the time spent by Non-Executive Directors in fulfilling their duties and the other directorships they hold.

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, was engaged to assist with the recruitment of a Non-Executive director for the South West Water board.

Nomination Committee composition and meetings

	Date of appointment to Pennon Nomination Committee	Attendance
Committee chairman		
Sir John Parker	April 2015	3/3
Committee members		
Martin Angle	December 2008	3/3
Neil Cooper	September 2014	2/3
Gill Rider	September 2012	3/3

The CEO also attends meetings when invited.

Board 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 2018 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.

As at the year end, 36% of Pennon Executive members are women. 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 27. In support of this aim, both our Chairman and our CEO have joined the 30% club, a UK campaign that supports the goal of women holding 30% of board seats and promotes initiatives to expand the female talent pipeline at all levels.

I am pleased to report that we received a favourable assessment in the Hampton-Alexander Review, published in November 2017, which looked at improving gender balance in FTSE Leadership. Pennon was placed 40th in the FTSE 250 and cited as one of the best improvers.

The Committee and the Board will continue to monitor and promote diversity across the Group with the aim of ensuring a diverse pipeline for succession to board and senior management positions. The Committee has approved an updated Diversity, Respect and Inclusion Policy for the Group, which encourages the growth of a diverse workforce where individuals from different backgrounds can fulfil their potential.

Our 2017 employee survey told us that 88% of our employees believe that people within Pennon Group are treated fairly regardless of race or ethnic origin. While we recognise this as good progress, we plan to increase our focus on ethnic diversity in the coming year. We continue to strive to ensure people with disabilities are given all the encouragement and support necessary and that Pennon is seen as a welcoming and inclusive place to work in all respects.

Information regarding the gender breakdown of the workforce is provided on page 27.

Sir John Parker
Nomination Committee Chairman

Remuneration Committee report

“ The Committee is responsible for ensuring remuneration is aligned with and supports the Group’s strategy, reflects our values and optimises performance. ”

Martin Angle
Remuneration Committee Chairman

The Committee met four 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:

- Determining the remuneration policy and future arrangements for the annual bonus and LTIP, with a particular focus on performance metrics and incentive levels to ensure these are aligned with the new management structure and strategic objectives and placing the same before the shareholders at the AGM 2017
- Annual executive salary review
- Annual review of the Chairman’s fee
- Determining performance targets in respect of the Annual Incentive Bonus Plan for 2017/18
- Reviewing drafts of the Directors’ remuneration report for 2016/17 and recommending it to the Board for approval for inclusion in the 2017 annual report
- Determining bonuses and deferred bonus awards pursuant to the Company’s Annual Incentive Bonus Plan in respect of the year 2016/17
- Approving the long-term incentive plan (LTIP) awards for the year
- Approving the release of the 2014 deferred bonus share awards and the vesting of executive share options pursuant to the Annual Incentive Bonus Plan
- Determining the outcome of the 2014 Performance and Co-investment Plan awards
- Reviewing and agreeing to recommend the removal of the coinvestment obligation under the Performance and Co-investment Plan, and an increase in our shareholding guidelines
- Reviewing the results of the Committee’s performance evaluation and instigating appropriate changes.

The Committee’s focus for 2018/19

- Ensure that targets are stretching but also fair and achievable, so that they act to retain, motivate and incentivise the executive to deliver the Group’s strategic goals and to create long-term value for shareholders
- Monitor on an ongoing basis the alignment of executive pay and benefits with the strategic direction of the Group to ensure these support the long-term success of the Company and promote its values
- Improve the process around, and disclosure of, personal bonus targets
- Undertake a review of the Committee’s independent remuneration consultants
- Consider and respond to the remuneration-related changes included in the new version of the UK Corporate Governance Code, due to be published in June 2018.

Remuneration Committee composition and meetings

	Date of appointment to Pennon Remuneration Committee	Attendance
Committee chairman		
Martin Angle	December 2008	4/4
Committee members		
Neil Cooper	September 2014	3/4
Gill Rider	September 2012	4/4

In accordance with the Code, all of the Committee members are independent Non-Executive Directors. 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.

The Committee is advised by Deloitte, an independent remuneration consultant, to ensure remuneration is determined impartially. The Committee is also supported by the Group director of Human Resources and the Group General Counsel and Company Secretary.

Martin D Angle

Remuneration Committee Chairman

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 people 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 2017/18

	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	518	30	450	-	155	1,153
Susan Davy	396	28	346	-	113	883
Non-Executive Directors						
Sir John Parker	270	-	-	-	-	270
Gill Rider	74	-	-	-	-	74
Martin Angle	67	-	-	-	-	67
Neil Cooper	66	-	-	-	-	66

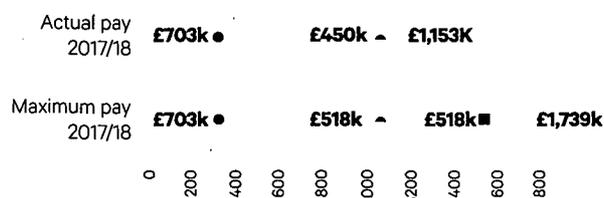
See the full single total figure of remuneration tables on page 93

 READ MORE PAGES 93 TO 95

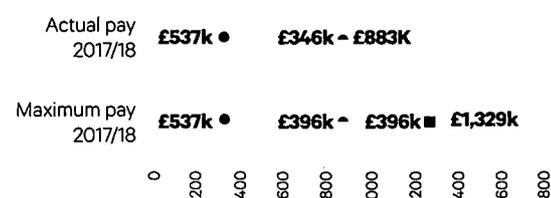
Total remuneration opportunity and outcome

Estimated zero vesting for LTIP reduces actual remuneration outcome for the year.

Chris Loughlin



Susan Davy



● Fixed pay (salary, pension and benefits) ▲ Annual bonus ■ LTIP

No adjustments have been made for share price movements or payment of dividends.

 READ OUR REMUNERATION POLICY
www.pennon-group.co.uk/about-us/governance-and-remuneration

Annual Statement from the Chairman of the Remuneration Committee

“The Committee appreciated our shareholders’ strong endorsement of the revised remuneration policy prepared during the year.”

Martin Angle

Remuneration Committee Chairman



READ MORE ABOUT OUR STRATEGIC
PRIORITIES ON PAGES 16 AND 17

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 2018.

At our 2017 AGM, shareholders approved our revised remuneration policy with 98% of votes cast in favour of the resolution. The policy is available in full on our website at www.pennon-group.co.uk/about-us/governance-and-remuneration and a summary of the policy is provided on pages 88 to 90. We are not proposing any changes to the policy at this year’s AGM.

A significant proportion of the Executive Directors’ remuneration is provided as variable pay that rewards the achievement of stretching annual and long-term performance targets, which in turn are designed to ensure delivery of Pennon’s strategy and create shareholder value. The relationship between our strategy, performance and the remuneration of our Executive Directors is summarised opposite on page 87.

On pages 91 to 101 we set out our annual report on remuneration which contains the remuneration of the Directors for the year 2017/18. We also provide details of how our policy will be applied for 2018/19. This section of the report, together with this letter, is subject to an advisory shareholder vote at this year’s AGM.

Review of the year

Performance against bonus targets

The bonus outturns for the Executive Directors for 2017/18 reflect the Company’s strong achievements against corporate financial and operational targets and the Executive Directors’ performance against personal targets. Half of the bonus is deferred and held as shares.

Strong earnings growth was maintained across the Group and Pennon continued to make good progress towards delivering its long-term strategic priorities. Group underlying profit before tax was £259 million, an increase of 3.5% compared with 2016/17. Adjusted earnings per share (EPS) before deferred tax and non-underlying items was up 8.3% at 50.9p reflecting 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. South West Water’s cumulative return on regulated equity (RoRE) at 11.8% continues to lead the sector and Viridor generated EBITDA of £150.2 million during the year.

Our operational metrics incentivise our Executives to focus on the issues that really matter to our customers and other stakeholders. In our water business, the year-end outturn has been affected by the extreme cold weather in early March 2018, which caused an increase in supply interruptions, and while South West Water met its Outcome Delivery Incentive (ODI) leakage target of 84 megalitres per day, it did not achieve the additional stretch target of 82 megalitres a day.

In the waste business, although the ERF portfolio performed strongly throughout the year, various headwinds, particularly around commodity pricing of paper, meant that the recycling action plan was not delivered in full. Viridor increased its customer base from 31,990 customers in 2016/17 to 32,292 in 2017/18.

While personal targets amount to only 20% of overall performance, the Executive Directors performed extremely well in 2017/18. Their leadership and drive has resulted in excellent progress towards delivery of our strategic priorities. There have been many challenges and successes during the year and the resolution of our negotiations

on the Greater Manchester waste contract, which resulted in a positive financial outcome and the preservation of our relationship with the Authority, was a highlight for the team. Preparatory work on our PR19 business plan has produced the building blocks for a coherent and compelling submission, which will demonstrate our commitment to outstanding customer service and sharing reward.

The Committee recognises that positive steps have been taken during the year in relation to health and safety, with the development of HomeSafe and a 28% reduction in lost time injuries. Environmental performance has also improved, with a 6% reduction in wastewater pollution incidents in South West Water. The Committee and the Executive expect these trends to continue, as we strive towards a step change in performance in both areas.

Chris and Susan each completed actions that have established an effective Group structure, continuing the integration of the Group's shared support functions under a single Pennon umbrella, developing and embedding the high-calibre executive team put in place last year and ensuring succession plans are in place. This year saw the Group's transformation take a step further, with the successful implementation of business and financial systems and processes, which ensure we have the capability to face future commercial challenges.

Further details of bonus targets, measures and performance are set out on pages 93 and 94.

Long-term incentive plan outturn

We are disappointed that the overall estimated outturn for awards vesting in 2018 under the old Performance and Co-investment Plan is zero. This reflects that the Company's total shareholder return (TSR) for the three-year performance period is anticipated to be below the comparator index performance and the median of the FTSE 250, with the Company's share price having been affected by external market and political considerations.

In 2017 we were pleased that shareholders voted in favour of a new long-term incentive plan, which has allowed us to move away from TSR and introduce a set of new performance measures that are aligned with our strategic objectives.

Key remuneration decisions

For 2018/19, salaries for Executive Directors were increased by 2%, which will be lower than the pay increase awarded to the wider employee population.

Looking ahead to the annual bonus for 2018/19, we are maintaining our approach of setting measurable financial and customer-focused operational objectives. These objectives will support the delivery of our strategy and create value for our stakeholders.

Looking forward

The Committee will continue to monitor the proposed changes to the UK Corporate Governance Code with interest, including proposals to strengthen the employee voice, as well as the Government's intention to introduce mandatory pay ratio reporting.

We are constantly reviewing our remuneration arrangements and performance measures to ensure they are aligned with our strategy, best practice and provide shareholders with an appropriate level of transparency. The Committee appreciated the strong endorsement of last year's revised remuneration policy and we hope we can continue to rely on shareholders' support.

Martin D Angle

Remuneration Committee chairman

Link between strategy, 2018 performance and remuneration

Strategic priority	Performance measures	Remuneration impacts
Leadership in UK Water and Waste	TSR performance against comparator index (50% weighting) and FTSE 250 (50% weighting)	Performance and Co-Investment Plan outturn for awards granted in 2015 and 2016 (due to vest in 2018 and 2019 respectively)
	<ul style="list-style-type: none"> • EPS growth per annum (40% weighting) • Dividend growth per annum and dividend cover (40% weighting) • Average return on capital employed (20% weighting) 	LTIP outturn for awards granted in 2017 onwards
Leadership in cost base efficiency	Profit before tax (PBT) & RoRE	Annual bonus outturn – 50% PBT / 10% RoRE
Driving sustainable growth	Performance against operational metrics and personal measures that are key to meeting the needs of our customers, communities, employees and other stakeholders	Annual bonus outturn – 20% customer and operational targets / 20% personal objectives

Directors' remuneration policy

Introduction

The current Directors' remuneration policy was approved by shareholders at the Company's AGM held on 6 July 2017.

The Committee's intention is to seek approval for the Company's remuneration policy at the end of the usual three-year cycle, in accordance with section 439A of the Companies Act 2006. Unless the Directors wish to amend the remuneration policy in the meantime, it will be submitted for shareholder approval at the 2020 AGM, following a review to be carried out by the Committee in 2019/20.

The remuneration policy tables for Executive and Non-Executive Directors are set out below for information. The policy is displayed in its entirety on the Company's website at www.pennon-group.co.uk/about-us/governance-and-remuneration and is available upon request from the Group Company Secretary.

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 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			
<p>Set at a competitive level to attract and retain high calibre people to meet the Company's strategic objectives in an increasingly complex business environment.</p> <p>Base salary reflects the scope and responsibility of the role as well as the skills and experience of the individual.</p>	<p>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.</p> <p>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.</p>	<p>When reviewing salaries the Committee has regard to the following factors:</p> <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. <p>There is no overall maximum.</p>	<p>None, although personal and Company performance are factors considered when reviewing salaries.</p>
Benefits			
<p>Benefits provided are consistent with the market and level of seniority to aid retention of key skills to assist in meeting strategic objectives.</p>	<p>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.</p> <p>In the event that an Executive Director is required to relocate, relocation benefits may be provided.</p>	<p>The cost of insurance benefits may vary from year to year depending on the individual's circumstances.</p> <p>There is no overall maximum benefit value but the Committee aims to ensure that the total value of benefits remain proportionate.</p>	<p>None.</p>
Annual bonus			
<p>Incentivises the achievement of key performance objectives aligned to the strategy of the Company.</p>	<p>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.</p> <p>A portion of any bonus is deferred into shares in the Company which are normally released after three years. Normally 50% is deferred.</p> <p>Any dividends on the shares during this period are paid to the Directors.</p> <p>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.</p>	<p>The maximum bonus potential for each Director is 100% of base salary.</p>	<p>Performance targets relate to corporate and personal objectives which are reviewed each year.</p> <p>For 2018/19, 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.</p> <p>The measures, weighting and threshold levels may be adjusted for future years.</p> <p>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.</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
Long-term incentive plan (LTIP)			
Provides alignment to the achievement of the Company's strategic objectives and the delivery of sustainable long-term value to shareholders.	<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>	The maximum annual award is 150% of base salary.	<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 2018/19 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 Performance conditions set under the previous remuneration policy (approved at the 2014 AGM) will continue to apply to awards granted in 2015 and 2016. These awards are due to vest in 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>
Shareholding requirements			
Create alignment between executives and shareholders and promote long-term stewardship.	200% of salary for both the CEO and CFO.		

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
Pension			
Provides funding for retirement and aids retention of key skills to assist in meeting the Company's strategic objectives.	<p>Defined benefit pension arrangements are closed to new entrants. Defined contribution pension arrangements have been available to new staff since 2008.</p> <p>A cash allowance may be provided as an alternative and/or in addition where pension limits have been reached.</p>	<p>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.</p> <p>Legacy defined benefit pension arrangements will continue to be honoured.</p> <p>Whilst one Executive Director is a pension member there are no further prospective accruals in respect of defined benefit pension arrangements.</p>	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.

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.

Annual report on remuneration

Introduction

This section sets out how the Company has applied its remuneration policy in the year, and details how the new policy will be implemented for the year 2018/19.

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 5 July 2018.

Operation of the remuneration policy for 2018/19

A summary of the specific remuneration arrangements for Executive Directors in 2018/19 is described below:

Base salary	<p>2018/19 salaries are:</p> <ul style="list-style-type: none"> • Chris Loughlin: £528,003 • Susan Davy: £403,767 <p>Salaries were increased by 2%, which was lower than increases for all employees.</p>		
Pension and benefits	<p>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 pension scheme.</p>		
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.</p> <p>For 2018/19, 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 customer and 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="0" style="width: 100%;"> <tr> <td style="vertical-align: top;"> <p>Water metrics</p> <ul style="list-style-type: none"> • Service incentive mechanism (SIM) • Bathing water quality • Leakage • Wastewater pollution incidents • Duration of interruptions to supply • Water and wastewater asset reliability. </td> <td style="vertical-align: top;"> <p>Waste metrics</p> <ul style="list-style-type: none"> • ERF availability • Delivery against recycling action plan • Growth in customer base </td> </tr> </table> <p>20% based on personal objectives. These will be relevant to the individual, and will include the following:</p> <ul style="list-style-type: none"> • Lead and develop an innovative PR19 business plan to maximise the potential of a positive outcome for South West Water, its customers and other stakeholders and work with government to achieve the same, gaining Board approval and submitting a high quality bid to Ofwat; • Undertake a strategic review of our recycling businesses in light of the Government's waste strategy, developing and gaining Board approval for an appropriate strategy for Viridor; • Build on the trust and engagement of our 5,000 employees to support the delivery of our strategy; • Continue to refine and extend the reach of the organisation's succession and talent management processes; • Continue to embed HomeSafe across the entire Group and drive further improvement in health and safety performance; <p>In addition, the CFO has objectives around the delivery of a sustainable financing strategy and the embedding of new financial systems and processes.</p> <p>For bonuses paid in respect of 2014/15 onwards, both malus and clawback apply as described in the remuneration policy.</p>	<p>Water metrics</p> <ul style="list-style-type: none"> • Service incentive mechanism (SIM) • Bathing water quality • Leakage • Wastewater pollution incidents • Duration of interruptions to supply • Water and wastewater asset reliability. 	<p>Waste metrics</p> <ul style="list-style-type: none"> • ERF availability • Delivery against recycling action plan • Growth in customer base
<p>Water metrics</p> <ul style="list-style-type: none"> • Service incentive mechanism (SIM) • Bathing water quality • Leakage • Wastewater pollution incidents • Duration of interruptions to supply • Water and wastewater asset reliability. 	<p>Waste metrics</p> <ul style="list-style-type: none"> • ERF availability • Delivery against recycling action plan • Growth in customer base 		

Annual report on remuneration continued

Long-term incentive plan	Maximum award of 150% of base salary for both the Chief Executive Officer and the Chief Financial Officer. For 2018/19, performance measures will be EPS growth, a sustainable dividend measure and RoCE, with targets set as follows:		
	EPS growth – 40% weighting		
		EPS growth pa	Vesting
	Threshold	6%	25%
	Maximum	10%	100%
	Straight-line vesting between threshold and maximum.		
	Sustainable dividend measure (dividend growth and dividend cover) – 40% weighting		
	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. There is then an EBITDA dividend cover target which operates as follows:		
		EBITDA dividend cover	Vesting
	Threshold	2.6	25%
Maximum	3.6	100%	
Straight-line vesting between threshold and maximum.			
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).			
For the purpose of the calculation, dividend cover would be based on the policy of 4% pa above RPI.			
Shareholding guideline	Return on capital employed (RoCE)* – 20% weighting		
		Average RoCE	Vesting
	Threshold	8%	25%
	Maximum	10%	100%
	* RoCE is defined as: (underlying 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 made from 2015/16 both malus and clawback apply and a holding period applies in respect of any shares that 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.		
	200% of salary for both the CEO and CFO.		

Non-Executive Director fees

Non-Executive Director fees for 2018/19 are set out below. They include an increase of 2% approved by the Board for the Non-Executive Directors, effective from 1 April 2018. The Chairman declined to accept an increase for 2018/19.

Role	Fees £
Chairman	270,331
Basic Non-Executive Director fee	48,141
Additional fees	
Senior Independent Director fee	7,140
Additional fee for chairman of the Audit Committee	14,495
Additional fee for chairman of the Remuneration Committee	10,353
Additional fee for chairman of the Sustainability Committee	10,353
Committee fee	5,177

Single total figure of remuneration tables (audited information)

	Base 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)	
	2017/18	2016/17	2017/18	2016/17	2017/18	2016/17	2017/18 ⁽ⁱⁱⁱ⁾	2016/17	2017/18	2016/17	2017/18	2016/17
Executive Directors												
Chris Loughlin	518	510	30	27	450	429	-	92	155	153	1,153	1,211
Susan Davy	396	390	28	18	346	332	-	34	113	109	883	883
Non-Executive Directors												
Sir John Parker	270	266	-	-	-	-	-	-	-	-	270	266
Gill Rider	74	72	-	-	-	-	-	-	-	-	74	72
Martin Angle	67	67	-	-	-	-	-	-	-	-	67	67
Neil Cooper	66	66	-	-	-	-	-	-	-	-	66	66

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

(ii) Based on an estimated 0% vesting as referred to on page 95.

(iii) See page 95 for further information.

Annual bonus outturn for 2017/18

The performance targets set and the performance achieved in respect of the annual bonus for 2017/18 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
Underlying profit before tax (50% weighting)	£242.7m	£247.7m	£260.1m	£258.8m	470%
RoRE (10% weighting)	8.0%	9.0%	11.0%	11.8%	100%

Customer and operational metrics (20% weighting)	Target	Actual outturn	Target achieved
Water metrics			
Service incentive mechanism (SIM)			
• South West Water	85	85	Yes
• Bournemouth Water	87	88	Yes
Bathing water quality	< 5 beaches failing	0 beaches failing	Yes
Leakage	82 megalitres per day	83 megalitres per day	No
Wastewater pollution incidents			
• Category 1-2	2	3	No
• Category 3-4	218	237	No
Average duration of supply interruptions	0.228 hours per property	0.369 hours per property	No
Wastewater and waste asset reliability	Stable	Stable	Yes
Waste metrics			
ERF availability	92%	92%	Yes
Delivery against recycling action plan	Recycling action plan was not met in full		No
Growth in customer base		See page 86 for details	Yes

Personal objectives (20% weighting)

A summary of achievements in the year is as follows:

- Championed and supported the HomeSafe health and safety improvement programme. Rolled out across the organisation through e-learning and facilitated deployment at prioritised locations. Brand, vision, materials and plan have been established and well received by the organisation. Lost time injuries have reduced by 28% during the year
- Delivered on a series of Board priorities, achieved targeted synergies, delivered a positive outcome on the negotiations on the Greater Manchester waste contract, delivered the organic growth mandate, embedded and developed the Pennon Group Executive
- Initiated the strategy behind the PR19 business plan to ensure the production of a high quality submission to Ofwat
- Delivered a succession and talent plan approved by the Board
- Led the successful implementation of the revised Project Enterprise and other governance improvements.

Total outturn **87.0%**

Annual report on remuneration

continued

Susan Davy

Measure	Threshold	Target	Maximum	Actual outturn	Bonus outturn
Underlying profit before tax (50% weighting)					
	£242.7m	£247.7m	£260.1m	£258.8m	47.0%
RoRE (10% weighting)					
	8.0%	9.0%	11.0%	11.8%	10.0%
Customer and operational metrics (20% weighting)					
	Target		Actual outturn	Target achieved	
Water metrics					
Service incentive mechanism (SIM)					
• South West Water	85		85	Yes	
• Bournemouth Water	87		88	Yes	
Bathing water quality	< 5 beaches failing		0 beaches failing	Yes	
Leakage	82 megalitres per day		83 megalitres per day	No	5.0%
Wastewater pollution incidents					
• Category 1-2	2		3	No	
• Category 3-4	218		237	No	
Average duration of supply interruptions	0.228 hours per property		0.369 hours per property	No	
Wastewater and waste asset reliability	Stable		Stable	Yes	
Waste metrics					
ERF availability	92%		92%	Yes	7.0%
Delivery against recycling action plan	Recycling action plan was not met in full			No	
Growth in customer base	See page 86 for details			Yes	
Personal objectives (20% weighting)					
A summary of achievements in the year is as follows:					
• Developed financial systems and processes to support a modern commercial culture including the successful implementation of the revised Project Enterprise. Group-wide enterprise resource planning (ERP) successfully delivered to time and budget					
• Launched Pennon's tax strategy ahead of schedule					
• Initiated the strategy behind the PR19 business plan to ensure the production of a high quality submission to Ofwat					18.5%
• Outperformed shared service targets for 2017/18					
• Delivered against the funding and treasury strategy – successful hybrid issuance					
• Championed and supported the HomeSafe health and safety improvement programme					
• Delivered on a series of Board priorities, achieved targeted synergies, Greater Manchester contract resolution, supported the delivery of the organic growth mandate.					
Total outturn					87.5%

Performance and Co-investment Plan outturn for 2017/18

The PCP awards made on 1 July 2015, which are due to vest on 1 July 2018, are the awards included in the single figure table and currently it is estimated that the outturn will result in a zero vesting as set out in the table below.

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).

The calculation of TSR performance from the start of the performance period on 1 April 2015 to 9 May 2018 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 2018*	Vesting outturn*
Comparator index (50% of award)	Equal to index	15% above the index	Below the index	0%
FTSE 250 (excluding investment trusts) (50% of award)	Above 50th percentile	At or above 75th percentile	31.9%	0%
Total				0%

Straight-line vesting between points.

For below threshold performance for either performance condition, 0% vests in respect of that performance condition.

* 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 2018 to 30 June 2018) the achievement and the outturn is an estimate at the date of calculation (9 May 2018).

Vesting of an award is also subject to the 'underpin' described in the remuneration policy tables on page 89, which the Committee has determined to the date of this report would be satisfied, if any award was to vest.

Vested awards are subject to a two-year holding period during which clawback may be applied where the Committee considers it appropriate in certain circumstances. The circumstances in which clawback may be applied are material misstatement or serious misconduct. The holding period ends on 30 June 2020.

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 2018 (£000)
Chris Loughlin	-	-	155	155	67 (20 August 2019)	-
Susan Davy	28	-	85	113	65 (17 May 2034)	20 ⁽ⁱⁱ⁾

(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.

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 2017/18 comprised an employer's contribution of £13,878 and a cash sum of £85,085. 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.

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

Annual report on remuneration continued

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.

Directors' service contracts and 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)

* 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 2021
Martin Angle	28 November 2008	31 December 2018
Neil Cooper	17 July 2014	30 August 2020
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-month notice period from either side and for the Chairman's letter of appointment to contain a 12-month 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.

Non-Executive Director fees and benefits

The Non-Executive Directors' fees were increased by the Board for 2017/18 by 1.5%. The Chairman's increase approved by the Committee was also 1.5%.

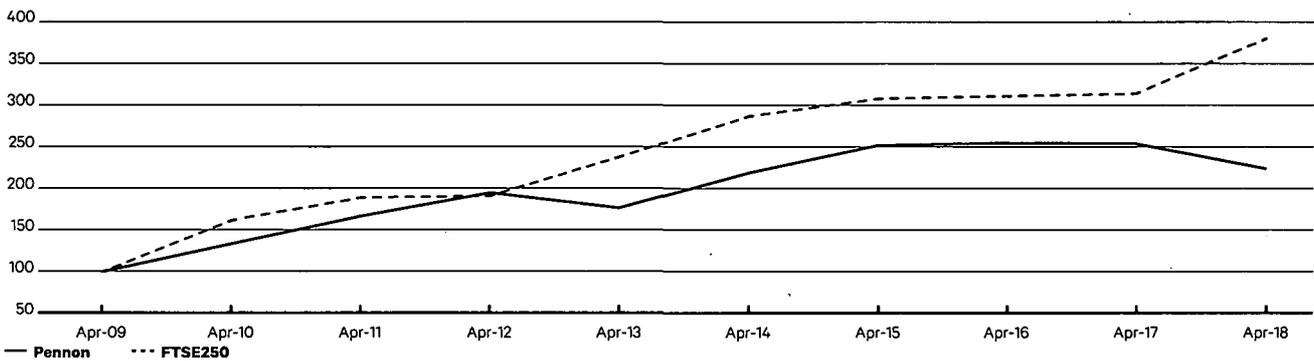
The Chairman's benefits comprise provision of a driver and vehicle, when appropriate for the efficient conduct of his duties. He is entitled to expenses on the same basis as for the other Non-Executive Directors.

All employee, performance and other contextual information

Historical TSR

The graph below shows the value, over the nine-year period ended on 31 March 2018, of £100 invested in Pennon Group on 1 April 2009 compared with the value of £100 invested in the FTSE 250 Index. The FTSE 250 index is a broad equity market index of which the Company is a constituent. In 2017 new long-term performance conditions were introduced.

Total shareholder return – Since April 2009



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 and 2017/18, 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⁾	2017/18
Average Executive Director single figure of remuneration (£000)	916	1,091	1,221	894	962	762	738	1,119	1,318	1,153
Annual bonus payout (% of maximum)	91.79	94.69	72.87	47.00	67.56	68.20	66.37	83.98	84.05	87.00
LTIP vesting (% of maximum) ^(iv)	67.30	50.00	79.30	50.00	30.20	0.00	37.90	37.90	20.40	0.00 ^(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 of 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 9 May 2018.

Comparison of CEO remuneration to employee remuneration

The table below shows the percentage change between 2016/17 and 2017/18 in base salary, benefits and annual bonus for the Group CEO, and all employees.

The percentage increase in average remuneration for employees is calculated using wages and salaries (excluding share-based payments) of £170.6 million (2016/17 £157.1 million), analysed into the three components in the table and the average number of employees of 5,014 (2016/17 4,799) 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	1.5%	9.87%	4.90%
All employees	2.7%	-5.6% ⁽¹⁾	13.5%

(1) The differential is driven predominantly by a change in how we record mileage, rather than a reduction in benefits.

The increase in the CEO's bonus outturn as a percentage of maximum was 2.95%. The CEO's salary increase for 2018/19 is 2.0%.

Annual report on remuneration continued

Relative importance of spend on pay

	2017/18 (£ million)	2016/17 (£ million)	Percentage change
Overall expenditure on pay ⁽ⁱ⁾	192.9	179.9	7.2%
Distributions to ordinary shareholders	149.5	138.5	7.9%
Distributions to perpetual capital security holders	25.3	20.3	24.6%
Purchase of property, plant and equipment (cash flow)	390.6	354.1	10.3%

(i) 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 past financial year.

Share award and shareholding disclosures (audited information)

Share awards granted during 2017/18

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	LTIP	150% of salary	776	25% of maximum	31 March 2020
Susan Davy			594		
Chris Loughlin	Deferred bonus	50% of bonus awarded	214	n/a	29 August 2020
Susan Davy			166		

LTIP awards were calculated using the share price of £8.027 being the average closing price over the five dealing days preceding the date of grant, which was 25 August 2017. Deferred bonus awards were calculated using the average share price at which shares were purchased on the market on 25 and 29 August 2017 in order to satisfy the award, which was £8.08691.

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. From 2017/18 the Committee has significantly increased these guidelines from 100% to 200% of salary for both the CEO and CFO. This may be built up over a period of no more than five years. Once obtained, the shareholding is then expected to be maintained by each Director and is revalued each year in accordance with the then prevailing share price and the Executive Director's salary.

The beneficial interests of the Executive Directors in the ordinary shares (40.7p each) of the Company as at 31 March 2018 (or date of cessation, if earlier) and 31 March 2017 together with their shareholding guideline obligation and interest are shown in the table below:

	Share interests (including connected parties) at 31 March 2018	Share interests (including connected parties) at 31 March 2017	Shareholding guideline	Shareholding guideline met?	Performance shares (subject to performance conditions)	Unvested awards	
						SAYE	Deferred bonus shares
Chris Loughlin	324,935	290,323	200%	Yes	201,519	4,984	64,387
Susan Davy	63,658	57,119	200%	No	156,461	2,635	42,836

Since 31 March 2018, 7,132 additional ordinary shares in the Company have been acquired by Chris Loughlin as a result of participation in the Company's Dividend Reinvestment Plan (DRIP) and the Company's Share Incentive Plan; and 86 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 2018 and 23 May 2018.

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 2018	Shares held at 31 March 2017
Sir John Parker	27,027	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 2018 and 23 May 2018.

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 23 May 2018 is as set out below:

	Awarded	Headroom	Total
Discretionary schemes	1.50%	3.50%	5%
All schemes	3.92%	6.08%	10%

Details of share awards

(a) 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 2017	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 2018	Date of end of period for qualifying conditions to be fulfilled	Expected date of release ⁽ⁱⁱ⁾
Chris Loughlin								
14/07/14	48,465	-	798.50p	11,437	92	-	13/07/17	-
01/07/15	49,352	-	810.50p	-	-	49,352	30/06/18	30/06/20
01/07/16	55,434	-	920.00p	-	-	55,434	30/06/19	30/06/19
25/08/17	-	96,733	802.70p	-	-	96,733	24/08/20	24/08/22
Susan Davy⁽ⁱⁱⁱ⁾								
14/07/14	17,893	-	798.50p	4,222	34	-	13/07/17	-
01/07/15	40,098	-	810.50p	-	-	40,098	30/06/18	30/06/20
01/07/16	42,391	-	920.00p	-	-	42,391	30/06/19	30/06/19
25/08/17	-	73,972	802.70p	-	-	73,972	24/08/20	24/08/22

(i) 20.4% of the July 2014 award shares vested on 24 August 2017 at a market price of 806.84p 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) Awards granted from 2015 onwards are subject to a two-year holding period following vesting.

(iii) 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.

Payments to past Directors

No payments to past Directors were made during the year.

Annual report on remuneration continued

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

The following Directors had or have a contingent interest in the number of ordinary shares (40.7p each) of the Company shown below, representing the total number of shares to which they have or would become entitled under the deferred bonus element of the Annual Incentive Bonus Plan (the bonus plan) at the end of the relevant qualifying period:

Director and date of award	Conditional awards held at 1 April 2017	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 2018	Date of end of period for qualifying conditions to be fulfilled
Chris Loughlin							
27/08/14	19,552	–	821.50p	19,552 ⁽ⁱ⁾	155	–	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
30/08/17	–	26,504	808.691p	–	–	26,504	29/08/20
Susan Davy⁽ⁱⁱ⁾							
27/08/14	7,543	–	821.50p	7,543 ⁽ⁱ⁾	60	–	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
30/08/17	–	20,503	808.691p	–	–	20,503	29/08/20

(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 15 September 2017 at 792.29p per share.

During the year the Directors received dividends on the above shares in accordance with the conditions of the bonus plan as follows: Chris Loughlin £20,654*; Susan Davy £10,743.

* 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 (which was withdrawn by the Board in November 2017 and replaced with a DRIP). 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 2017 given on page 98.

(c) 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 2017	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 2018	Options held at 31 March 2018	Exercise period/ maturity date
Chris Loughlin								
03/07/13	2,788	–	–	538.00p	–	643.40p	2,788	01/09/18 – 28/02/19
24/06/15	2,196	–	–	683.00p	–	643.40p	2,196	01/09/20 – 28/02/21
Susan Davy								
24/06/15	2,635	–	–	683.00p	–	643.40p	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 (Group director of Human Resources), and from Deloitte LLP. Deloitte LLP was appointed directly by the Committee.

Deloitte LLP assisted 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 2017/18 were £72,200 (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 resolutions to approve the Directors' remuneration report and the remuneration policy at the Annual General Meeting held on 6 July 2017, including votes for, against and withheld.

Annual report on remuneration	
For % (including votes at the Chairman's discretion)	98.79
Against %	1.21
Withheld number	223,594
Remuneration policy	
For % (including votes at the Chairman's discretion)	97.92
Against %	2.08
Withheld number	237,155

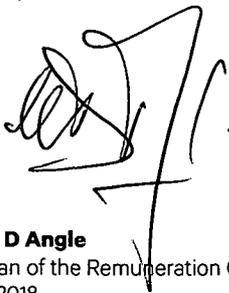
A vote withheld is not counted in the calculation of the proportion of votes 'for' and 'against' a resolution.

The Remuneration Committee is pleased to note that 99% of shareholders who voted approved the 2016/17 Directors' remuneration report and 98% voted in favour of the revised remuneration policy introduced last year. 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 108 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
24 May 2018

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 64 to 83 and 102 to 105 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 (pages 52 to 54 of the strategic report)
- likely future developments of the Company (page 23 of the strategic report)
- certain employee matters (page 26 and 27 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 (pages 42 to 51 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 66 and 67.

Financial results and dividend

The Directors recommend a final dividend of 26.62 pence per ordinary share to be paid on 4 September 2018 to shareholders on the register on 6 July 2018, making a total dividend for the year of 38.59 pence, the cost of which will be £162 million, resulting in a transfer to reserves of £38 million. The strategic report on pages 42 to 51 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 that 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.

The Group has policies in place covering health and safety, equal opportunities, diversity and inclusion, ethics and employee relations. In addition, the Board has a diversity policy details of which are set out in the report of the Nomination Committee on page 81. Information regarding the diversity of the workforce is provided on page 27.

Pennon respects the right to freedom of association and 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 workforce engagement and employment matters relating to the Group is set out on pages 26 and 27 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 2018 around 38% of the Group's employees were participating in these plans.

Greenhouse gas emissions

Change in emissions

Gross greenhouse gas emissions for the Group increased by 11% primarily as a result of Viridor's recently commissioned energy recovery facilities reaching their full operating capacity. 92% of our gross emissions are due to Viridor operations, 93% of which relate to landfill and ERFs. Our ERFs are fuelled by waste, composing of more than 50% biogenic or renewable carbon, which would otherwise have gone to landfill. This has a clear resulting carbon benefit, as a greater proportion of the energy embedded in the residual waste is extracted and methane generation from landfills is avoided.

Following a reduction last year, emissions from landfill increased by 12% because of higher waste inputs to these sites during 2017/18. This is due to an ongoing gap in alternative residual waste treatment capacity in the UK.

Our water businesses' energy usage has stayed effectively flat at 305 GWh compared to 307 GWh the previous year. This represents a balance between our continued significant efforts to improve energy efficiency in the face of some energy-intensive additional process equipment being installed to maintain compliance with regulation.

All Group companies benefitted from a continued reduction in the UK's average electricity grid emissions conversion factor, which fell from 0.44932 kgCO_{2e}/kWh to 0.38443 kgCO_{2e}/kWh between 2016/17 and 2017/18. This resulted in an overall reduction in the Group's Scope 2 emissions over the year and has helped both South West Water and Bournemouth Water to reduce their overall carbon footprint by around 8%.

The intensity metric has increased from 127 to 138 tCO_{2e}/£100,000 turnover reflecting an overall rise in Scope 1 and 2 emissions, as described above, which have grown at a faster rate than our increase in turnover.

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.

The methodology will be reviewed next year in light of the disposal by Viridor of its interest in Viridor Laing (Greater Manchester) Holdings Limited following the reset of the Greater Manchester contract.

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 2017/18 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 uses 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 Jacobs. 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

	2017/18	2016/17
Scope 1	1,797,147	1,576,428
Scope 2	123,665	144,707
Scope 3	65,186	60,760
Total gross emissions	1,985,997	1,781,895
Green tariff electricity offset	(1,738)	(1,774)
Exported renewable energy reduction (up to total amount of electricity purchased and consumed by organisation)	(121,927)	(142,933)
Total annual net emissions	1,862,333	163,718
Biogenic emissions outside of scopes	1,520,021	1,692,423
Intensity measure: tCO ₂ e (gross Scope 1+2)/£100,000 revenue	137.9	127.1

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.

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's Code of Conduct 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 forced labour 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 £0.1 million during the year (2016/17 £0.2 million).

Overseas branches

The Company has no overseas branches.

Pennon Group donations

During 2017/18 the Group provided a total of £151,000 in charitable donations.

No political donations were made or political expenditure incurred and no contributions were made to a non-EU political party (2016/17 nil).

Directors' report – other statutory disclosures continued

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 2017), which was valid as at 31 March 2018 and remains currently valid. No purchases were made during the year. As at 1 April 2017, 8,443 shares were held in treasury, with a nominal value of £3,436 and representing 0.002% of issued share capital. No treasury shares were reissued during the year.

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 2018:

- 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 156. 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 170. 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) £56,498,376 (such amount to be reduced by any shares allotted or rights granted under (ii) below in excess of £56,498,376); and
(ii) £112,996,752 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 2017 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;
- f) There are a number of agreements that 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.

There is no information to be disclosed under Listing Rule (LR) 9.8.4R. The Company has no long-term incentive arrangements in place under LR 9.4.2R (2) where the only participant is a Director and the arrangement is established specifically to facilitate, in unusual circumstances, the recruitment or retention of the individual.

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 66 and 67, 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 61) and the Directors' report 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 position and 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 64 to 83 and 102 to 105 was approved by the Board on 24 May 2018.

By Order of the Board



Helen Barrett-Hague

Group General Counsel and Company Secretary

24 May 2018

Our approach to finance is responsible and sustainable

**FINANCIAL STATEMENTS AND
SHAREHOLDER INFORMATION**

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

Opinion

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 2018 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.

We have audited the financial statements of Pennon Group plc which comprise:

Group	Parent company
Consolidated income statement	
Consolidated statement of comprehensive income	
Consolidated balance sheet	Balance sheet
Consolidated statement of changes in equity	Statement of changes in equity
Consolidated cash flow statement	Cash flow statement
Related notes 1 to 45 to the financial statements	Related notes 1 to 45 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.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report below. We are independent of the Group and parent company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard as applied to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Use of our report

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.

Conclusions relating to principal risks, going concern and viability statement

We have nothing to report in respect of the following information in the annual report, in relation to which the ISAs(UK) require us to report to you whether we have anything material to add or draw attention to:

- the disclosures in the annual report set out on pages 54 to 60 that describe the principal risks and explain how they are being managed or mitigated;
- the directors' confirmation set out on page 54 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 directors' statement set out on page 100 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
- whether the directors' statement in relation to going concern required under the Listing Rules in accordance with Listing Rule 9.8.6R(3) is materially inconsistent with our knowledge obtained in the audit; or
- the directors' explanation set out on page 61 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.

Overview of our audit approach

Key audit matters	<ul style="list-style-type: none"> • Revenue recognition across the Group's operations • Valuation of landfill related provisions (Viridor) • Valuation of the provision for doubtful debts (SWW) • Contract claims (Viridor)
Audit scope	<ul style="list-style-type: none"> • We performed an audit of the complete financial information of three components and audit procedures on specific balances for one component. • The components where we performed full or specific audit procedures accounted for 100% of Profit before taxation before non-underlying items, 100% of Revenue and 95% of Total assets.
Materiality	<ul style="list-style-type: none"> • Overall Group materiality of £12.9m which represents 5% of Profit before taxation before non-underlying items.

Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team. These matters were addressed in the context of our audit of the financial statements as a whole, and in our opinion thereon, and we do not provide a separate opinion on these matters.

Risk	Our response to the risk	Key observations communicated to the Audit Committee
<p>Revenue recognition across the Group's operations (£1,396.2 million, PY comparative £1,353.1 million)</p> <p>Risk direction</p>  <p>Refer to the Audit Committee Report (page 73); Accounting policies (page 119); and Note 4 of the Consolidated Financial Statements (page 127)</p> <p>The Group's material revenue streams relate to the provision of water and sewerage services by South West Water and Pennon Water Services 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 with 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 and Pennon Water Services</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 2018 is £615 million (2017: £72.2 million) for South West Water and £20.2 million for Pennon Water Services. <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. The accrued income balance at 31 March 2018 is £53.4 million (2017: £42.8 million). Accounting for revenue from long term service concession arrangements under IFRIC12 requires revenue to be recognised on construction, during service delivery and as a capital return on the asset. The determination of the margin allocated during the different phases of each service concession involves management judgement. At 31 March 2018 the Group has recognised contract receivables of £234.1 million (2017: £217.6 million) and other intangible assets of £69.2 million (2017: £61.3 million). 	<p>Our procedures include:</p> <p>South West Water and Pennon Water Services</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 assess the completeness of adjustments to reflect the accrual or deferral of revenue We tested key controls linked to system generated information and around the estimation process for measured revenue We compared the accrued income to bills raised post year end for a sample of customers, and compared management's history of estimating the accrued income balance to bills raised in the subsequent year to assess the accuracy of the accrued income balance 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, such as weather patterns and leaks in infrastructure network We tested whether contract terms and conditions were met and revenue 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 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>Viridor</p> <ul style="list-style-type: none"> We compared the key assumptions and estimates made by management in recognising accrued revenue in the current year to those applied in the prior year to identify significant changes. We analysed revenue trends and corroborated unusual movements to assess the accuracy of the accrued income balance 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 the IFRIC12 revenue recognised and assessed the allocation of consideration between the construction and operating services provided We agreed whether the revenue recognition policies adopted comply with IFRS, in particular the requirements of IFRIC 12, and that the margins used to recognise revenue are appropriate through testing that costs were allocated to the correct contracts and that revenue recognised, based on those costs, is reasonable and aligned with the individual contract models. We also compared the margins to those generated in prior years and to the latest projections for future years In performing our journal testing, we paid increased attention to entries impacting revenue, particularly those raised close to the balance sheet date. <p>We performed full and specific scope audit procedures over this risk area for three components, which covered 100% of the risk amount.</p>	<p>South West Water and Pennon Water Services</p> <p>We concluded that the estimation process undertaken by management to calculate the measured income accrual reflects latest operational factors in the key assumptions and results in an acceptable income accrual.</p> <p>Viridor</p> <p>We concluded that accrued income has been appropriately recognised, and IFRIC 12 appropriately applied.</p>
<p>Valuation of landfill related provisions (Viridor) (£191.9 million, PY comparative £183.8 million)</p> <p>Risk direction</p>  <p>Refer to the Audit Committee Report (page 73); Accounting policies (page 119); and Note 4 of the Consolidated Financial Statements (page 127).</p> <p>Landfill related provisions of £191.9 million (2017: £183.8 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, where breaches have been identified, is a key estimate for the remediation provision.</p> <p>We focused on this area given there is a risk that provisions could be misstated due to the complexity of factors to be assessed and assumptions, such as discount rates, applied by management being inappropriate, including the impact of any management bias.</p>	<p>Our procedures include:</p> <ul style="list-style-type: none"> We tested the aftercare, restoration and remediation provision models, and verified that the models are arithmetically accurate We evaluated the forecast costs in the models, agreeing these to supporting evidence such as budgets and supplier cost quotations and current performance, including prices charged by contractors in current year for significant sites 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 compared the key assumptions used in the calculation of the provisions, including the discount rates, inflation rates, void space and remaining lives of the sites, to available market information We 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 performed sensitivity analysis on these key assumptions We tested the appropriateness of journal entries impacting landfill related provisions, particularly those raised close to the balance sheet date. <p>We performed full scope audit procedures over this risk area at Viridor, which covered 100% of the risk amount.</p>	<p>We concluded that management's real risk free rate of 2.325% applied to the most significant provision (aftercare) is within an acceptable range (2.00% to 2.54%). We consider key assumptions supporting the landfill related provisions reflect management's best estimates, informed by latest external and internal data, resulting in an acceptable provision balance.</p>

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

continued

Risk	Our response to the risk	Key observations communicated to the Audit Committee
<p>Valuation of the provision for doubtful debts (South West Water) (£88.5 million, PY comparative £90.0 million)</p> <p>Risk direction</p>  <p><i>Refer to the Audit Committee Report (page 73); Accounting policies (page 119); and include d within the total Group balance per Note 22 of the Consolidated Financial Statements (page 144)</i></p> <p>The South West Water provision is calculated using a combination of system generated information on historic debt recovery rates and management's judgement of the future likely recovery rates.</p> <p>There is a risk that the assumptions used by management in calculating the bad debt provision may be susceptible to management bias and the valuation of the provision against trade receivables may be misstated. We have therefore focused on this key audit matter.</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 performed full scope audit procedures over this risk area at South West Water, which covered 100% of the risk amount.</p>	<p>We concluded that the doubtful debt provision is within an acceptable range (£80.7 million to £91.2 million) and reflects recent history of collection of outstanding debts.</p>
<p>Contract claims (Viridor)</p> <p>Risk direction</p>  <p><i>Refer to the Audit Committee Report (page 73); Accounting policies (page 119); and Note 4 of the Consolidated Financial Statements (page 127)</i></p> <p>During the year, there was significant activity on two of Viridor's key contracts.</p> <p>Firstly, there was a reset of contracts associated with the Greater Manchester Waste Disposal Authority. This resulted in the settlement of outstanding claims and counter claims, a write down of a financial asset and recognition of an increase in share of profit after tax from joint ventures. These transactions have been presented as non-underlying items in the financial statements. We have focussed on the key judgements made by management and accounting treatment applied to this significant event.</p> <p>Viridor is also contracted with Glasgow City Council to construct a Recycling and Renewable Energy Centre in Glasgow. Viridor terminated the contract with the original principal contractor in November 2016 and is overseeing the remaining construction. Expenditure to complete construction is expected to exceed the original target and management has accounted for what it believes its contractual rights are.</p> <p>Where contract claims arise, the claims and the related accounting can be complex. We focused on this area given there is risk of challenge of the legal position taken and higher judgement involved in assessing the collectability of amounts recorded.</p>	<p>For the Manchester contract our procedures include:</p> <ul style="list-style-type: none"> • We inspected contracts and settlement agreements and agreed the accounting treatment of settled claims • We evaluated whether the allocation of income to the various settlement arrangements was appropriate and assessed whether the timing of revenue recognition was in accordance with IFRS. • We tested the revised cash flow models over the contract life and ensured recognition of revenue and costs are in accordance with IAS 18. <p>For the Glasgow contract our procedures include:</p> <ul style="list-style-type: none"> • We obtained an understanding of the key assumptions and estimates made by management in accounting for material claims, assessing for evidence of management bias and concluding on whether we concur with accounting estimates made by management • We inspected legal advice or opinion management have obtained in relation to contract positions, quantum of costs and amounts recoverable • We inquired of management and assessed other evidence, including board minutes, to test the completeness of amounts recorded in relation to contract claims • We inspected external data, including market announcements, analyst reports and financial reports, to assess the recoverability of amounts due from contractors and whether there is a need for a reserve to reflect any credit default risk. <p>We performed full scope audit procedures over this risk area in one location, which covered 100% of the risk amount.</p>	<p>For the Manchester contract, we concluded that the accounting treatment applied and judgements made by management, particularly relating to the allocation of income and timing of revenue recognition was appropriate.</p> <p>In relation to the Glasgow contract, we concluded that the accounting position taken by management, including the recoverability of amounts due from contractors, is appropriate and is based on supporting legal and financial analysis.</p>

In the prior year, our auditor's report included a key audit matter in relation to completeness of provisions for uncertain tax positions and related tax disclosures. We reported that the Group had reached resolution with HMRC on a number of areas, reducing the level of uncertainty over the year end tax liability and the risk of material misstatement. In the current year we concluded this is not a key audit matter.

In the prior year, our auditor's report also included a key audit matter in relation to valuation of Viridor's non-current assets. 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 financial performance in the business plan, which supports the carrying value, will be achieved. There are no indicators of impairment.

An overview of the scope of our audit

Tailoring the scope

Our assessment of audit risk, our evaluation of materiality and our allocation of performance materiality determine our audit scope for each entity within the Group. Taken together, this enables us to form an opinion on the consolidated financial statements. We take into account size, risk profile, the organisation of the group and effectiveness of group-wide controls, changes in the business environment and other factors such as recent internal audit results when assessing the level of work to be performed at each entity.

In assessing the risk of material misstatement to the Group financial statements, and to ensure we had adequate quantitative coverage of significant accounts in the financial statements, of the six reporting components of the Group, we selected four components covering Pennon Group plc, Viridor, South West Water and Pennon Water Services, which represent the principal business units within the Group.

Of the four components selected, 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. For the remaining one component ("specific scope component"), we performed audit procedures on specific accounts within that component that we considered had the potential for the greatest impact on the significant accounts in the financial statements either because of the size of these accounts or their risk profile.

The reporting components where we performed audit procedures accounted for 100% (2017: 100%) of the Group's Profit before taxation before non-underlying items, 100% (2017: 100%) of the Group's Revenue and 95% (2017: 95%) of the Group's Total assets. For the current year, the full scope components contributed 100% (2017: 100%) of the Group's Profit before taxation before non-underlying items, 88% (2017: 100%) of the Group's Revenue and 94% (2017: 95%) of the Group's Total assets. The specific scope component contributed 0.4% (2017: 0%) of the Group's Profit before taxation before non-underlying items, 12% (2017: 0%) of the Group's Revenue and 1% (2017: 0%) of the Group's Total assets. The audit scope of these components may not have included testing of all significant accounts of the component but will have contributed to the coverage of significant accounts tested for the Group.

Of the remaining two components that together represent less than 1% of the Group's profit before taxation before non-underlying items, none are individually greater than 1% of the Group's profit before taxation before non-underlying items. For these components, we performed other procedures, including analytical review procedures, testing of consolidation journals and intercompany eliminations to respond to any potential risks of material misstatement to the Group financial statements.

Changes from the prior year

There was one change in scope from the prior year. Pennon Water Services, a new business unit, was designated as a specific scope component for the current year audit.

Involvement with component teams

In establishing our overall approach to the Group audit, we determined the type of work that needed to be undertaken at each of the components by us, as the primary audit engagement team, or by component auditors operating under our instruction. There are three key locations where we perform audit procedures for the Group and its components, being Exeter, Taunton and Bournemouth. The Pennon Group plc and South West Water accounting functions are based in Exeter and the audit teams of these components are led by the Senior Statutory Auditor. Separate teams audit full scope component, Viridor, in Taunton, and specific scope component, Pennon Water Services, in Bournemouth. Where the work was performed by component auditors, we determined the appropriate level of involvement to enable us to determine that sufficient audit evidence had been obtained as a basis for our opinion on the Group as a whole.

The primary team interacted regularly with the component teams where appropriate during various stages of the audit, reviewed key audit working papers on risk areas, attended key meetings with local management and were responsible for the scope and direction of the audit process. This, together with the additional procedures performed at Group level, gave us appropriate evidence for our opinion on the Group financial statements.

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 £12.9 million (2017: £12.5 million), which is 5% (2017: 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 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.

We determined materiality for the Parent Company to be £7.3 million (2017: £7.1 million), which is 75% (2017: 75%) of Group performance materiality.

Starting basis	Reported profit before taxation £262.9 million (2017: £210.5 million).
Adjustments	Non-underlying items – increase basis by £4.1 million (2017: £39.5 million).
Materiality	Totals £258.8 million (2017: £250.0 million) profit before taxation before non-underlying items. Materiality of £12.9 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% (2017: 75%) of our planning materiality, namely £9.7m (2017: £9.4m). We have set performance materiality at this percentage based on our assessment of the Group's internal control environment and the extent and nature of audit findings identified in the prior period. This basis is consistent with the prior year.

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

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 £2.9m to £9.0m (2017: £4.4m to £8.4m).

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 £0.7m (2017: £0.6m), 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.

Other information

The other information comprises the information included in the annual report set out on pages 1 to 101, other than the financial statements and our auditor's report thereon. The directors are responsible for the other information.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in this report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of the other information, we are required to report that fact.

We have nothing to report in this regard.

In this context, we also have nothing to report in regard to our responsibility to specifically address the following items in the other information and to report as uncorrected material misstatements of the other information where we conclude that those items meet the following conditions:

- **Fair, balanced and understandable set out on page 101** – the statement given by the directors that they consider the annual report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the group's performance, business model and strategy, is materially inconsistent with our knowledge obtained in the audit; or
- **Audit committee reporting set out on pages 73 to 76** – the section describing the work of the audit committee does not appropriately address matters communicated by us to the audit committee; or

- **Directors' statement of compliance with the UK Corporate Governance Code set out on page 6** – the parts of the directors' statement required under the Listing Rules relating to the company's compliance with the UK Corporate Governance Code containing provisions specified for review by the auditor in accordance with Listing Rule 9.8.10R(2) do not properly disclose a departure from a relevant provision of the UK Corporate Governance Code.

Opinions 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.

In our opinion, 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 and those reports have been prepared in accordance with applicable legal requirements;
- the information about internal control and risk management systems in relation to financial reporting processes and about share capital structures, given in compliance with rules 7.2.5 and 7.2.6 in the Disclosure Rules and Transparency Rules sourcebook made by the Financial Conduct Authority (the FCA Rules), is consistent with the financial statements and has been prepared in accordance with applicable legal requirements; and
- information about the company's corporate governance code and practices and about its administrative, management and supervisory bodies and their committees complies with rules 7.2.2, 7.2.3 and 7.2.7 of the FCA Rules.

Matters on which we are required to report by exception

In the light of the knowledge and understanding of the group and the parent company and its environment obtained in the course of the audit, we have not identified material misstatements in:

- the strategic report or the directors' report; or
- the information about internal control and risk management systems in relation to financial reporting processes and about share capital structures, given in compliance with rules 7.2.5 and 7.2.6 of the FCA Rules.

We have nothing to report in respect of the following matters in relation to which the Companies Act 2006 requires us to report to you if, in our opinion:

- 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
- a Corporate Governance Statement has not been prepared by the company.

Responsibilities of directors

As explained more fully in the directors' responsibilities statement set out on page 101, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the group and parent company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the group or the parent company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Explanation as to what extent the audit was considered capable of detecting irregularities, including fraud

The objectives of our audit, in respect to fraud, are: to identify and assess the risks of material misstatement of the financial statements due to fraud; to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and to respond appropriately to fraud or suspected fraud identified during the audit. However, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.

Our approach was as follows:

- We obtained an understanding of the legal and regulatory frameworks that are applicable to the group and determined that the most significant are:
 - Companies Act 2006
 - Financial Reporting Council (FRC) and the UK Corporate Governance Code
 - Tax legislation (governed by HM Revenue & Customs)
 - Health and Safety legislation
 - Environment Agency environmental permits
 - Ofwat regulations
 - UK listing rules
- We understood how Pennon Group plc is complying with those frameworks by reading internal policies and codes of conduct and assessing the entity level control environment, including the level of oversight of those charged with governance. We made enquiries of the Group's legal counsel, regulatory team and internal audit of known instances of non-compliance or suspected non-compliance with laws and regulations. We corroborated our enquiries through review of correspondence with regulatory bodies. We designed our audit procedures to identify non-compliance with such laws and regulations identified in the paragraph above. As well as enquiry and attendance at meetings, our procedures involved a review of the reporting to the above committees and a review of board meetings and other committee minutes to identify any non-compliance with laws and regulations. Our procedures also involved journal entry testing, with a focus on journals meeting our defined risk criteria based on our understanding of the business.

- We assessed the susceptibility of the group's financial statements to material misstatement, including how fraud might occur by making enquiries of senior management, including the Chief Executive Officer, Chief Financial Officer, Head of Internal Audit and Audit Committee Chairman. We planned our audit to identify risks of management override, tested higher risk journal entries and performed audit procedures to address the potential for management bias, particularly over areas involving significant estimation and judgement. Further discussion of our approach to address the identified risks of management override are set out in the key audit matters section of our report.
- Based on this understanding we designed our audit procedures to identify non-compliance with such laws and regulations. Our procedures involved making enquiries of key management and legal counsel, reviewing key policies, inspecting legal registers and correspondence with regulators and reading key management meeting minutes. We also completed procedures to conclude on the compliance of significant disclosures in the Annual Report and Accounts with the requirements of the relevant accounting standards, UK legislation and the UK Corporate Governance Code.
- We communicated regularly with the component teams and attended key meetings with the component teams, management and legal counsel in order to identify and communicate any instances of non-compliance with laws and regulations.
- The Group operates in the water and waste sectors which are highly regulated environments. As such the Senior Statutory Auditor reviewed the experience and expertise of the engagement team to ensure that the team had the appropriate competence and capabilities, which included the use of an expert where appropriate.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at <https://www.frc.org.uk/auditorsresponsibilities>. This description forms part of our auditor's report.

Other matters we are required to address

- We were appointed by the company at its annual general meeting on 31 July 2014 to audit the financial statements for the year ending 31 March 2015 and subsequent financial periods.
- The period of total uninterrupted engagement including previous renewals and reappointments is 4 years, covering the years ending 31 March 2015 to 31 March 2018.
- The non-audit services prohibited by the FRC's Ethical Standard were not provided to the group or the parent company and we remain independent of the group and the parent company in conducting the audit.
- The audit opinion is consistent with the additional report to the audit committee.

Debbie O'Hanlon

Senior statutory auditor

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

24 May 2018

Notes:

- (1) The maintenance and integrity of the Pennon Group plc web site 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 2018

	Notes	Before non-underlying items 2018 £m	Non-underlying items (note 6) 2018 £m	Total 2018 £m	Before non-underlying items 2017 £m	Non-underlying items (note 6) 2017 £m	Total 2017 £m
Revenue	5	1,393.0	3.2	1,396.2	1,353.1	-	1,353.1
Operating costs	7						
Employment costs		(192.9)	-	(192.9)	(179.7)	(1.1)	(180.8)
Raw materials and consumables used		(108.7)	-	(108.7)	(115.8)	-	(115.8)
Other operating expenses		(581.8)	-	(581.8)	(571.6)	(9.6)	(581.2)
Earnings before interest, tax, depreciation and amortisation	5	509.6	3.2	512.8	486.0	(10.7)	475.3
Depreciation and amortisation	7	(185.7)	-	(185.7)	(181.4)	-	(181.4)
Operating profit	5	323.9	3.2	327.1	304.6	(10.7)	293.9
Finance income	8	24.2	-	24.2	36.3	16.0	52.3
Finance costs	8	(98.7)	(21.6)	(120.3)	(95.1)	(4.8)	(139.9)
Net finance costs	8	(74.5)	(21.6)	(96.1)	(58.8)	(28.8)	(87.6)
Share of post-tax profit from joint ventures	20	9.4	22.5	31.9	4.2	-	4.2
Profit before tax	5	258.8	4.1	262.9	250.0	(39.5)	210.5
Taxation (charge)/credit	9	(44.4)	3.4	(41.0)	(58.4)	28.4	(30.0)
Profit for the year		214.4	7.5	221.9	191.6	(11.1)	180.5
Attributable to:							
Ordinary shareholders of the parent		193.1	7.5	200.6	175.4	(11.1)	164.3
Non-controlling interests		(0.2)	-	(0.2)	-	-	-
Perpetual capital security holders		21.5	-	21.5	16.2	-	16.2
Earnings per ordinary share (pence per share)	11						
- Basic				48.0			39.8
- Diluted				47.8			39.6

Consolidated statement of comprehensive income

For the year ended 31 March 2018

	Notes	Before non-underlying items 2018 £m	Non-underlying items (note 6) 2018 £m	Total 2018 £m	Before non-underlying items 2017 £m	Non-underlying items (note 6) 2017 £m	Total 2017 £m
Profit for the year		214.4	7.5	221.9	191.6	(11.1)	180.5
Other comprehensive (loss)/ income							
<i>Items that will not be reclassified to profit or loss</i>							
Remeasurement of defined benefit obligations	30	24.5	-	24.5	(23.6)	-	(23.6)
Income tax on items that will not be reclassified	9, 31	(4.2)	-	(4.2)	4.7	(1.4)	3.3
Total items that will not be reclassified to profit or loss		20.3	-	20.3	(18.9)	(1.4)	(20.3)
<i>Items that may be reclassified subsequently to profit or loss</i>							
Share of other comprehensive (loss)/income from joint ventures	20	(2.7)	-	(2.7)	0.3	-	0.3
Cash flow hedges		20.5	-	20.5	4.9	-	4.9
Income tax on items that may be reclassified	9, 31	(3.5)	-	(3.5)	(1.0)	(0.3)	(1.3)
Total items that may be reclassified subsequently to profit or loss		14.3	-	14.3	4.2	(0.3)	3.9
Other comprehensive income/(loss) for the year net of tax	36	34.6	-	34.6	(14.7)	(1.7)	(16.4)
Total comprehensive income for the year		249.0	7.5	256.5	176.9	(12.8)	164.1
Total comprehensive income attributable to:							
Ordinary shareholders of the parent		227.7	7.5	235.2	160.7	(12.8)	147.9
Non-controlling interests		(0.2)	-	(0.2)	-	-	-
Perpetual capital security holders		21.5	-	21.5	16.2	-	16.2

The notes on pages 119 to 168 form part of these financial statements.

Balance sheets

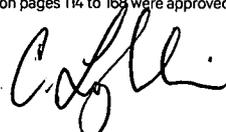
At 31 March 2018

	Notes	Group		Company	
		2018 £m	2017 £m	2018 £m	2017 £m
Assets					
Non-current assets					
Goodwill	15	385.0	385.0	-	-
Other intangible assets	16	72.6	67.1	-	-
Property, plant and equipment	17	4,310.6	4,103.2	0.2	0.2
Other non-current assets	19	263.5	308.0	846.0	1,011.6
Deferred tax assets	31	-	-	1.6	2.3
Derivative financial instruments	23	70.5	73.6	4.2	3.1
Investments in subsidiary undertakings	20	-	-	1,980.8	1,624.2
Investments in joint ventures	20	22.8	0.1	-	-
		5,125.0	4,937.0	2,832.8	2,641.4
Current assets					
Inventories	21	24.6	21.3	-	-
Trade and other receivables	22	416.0	340.8	42.7	127.3
Derivative financial instruments	23	12.9	14.1	6.4	1.1
Cash and cash deposits	25	585.3	598.1	303.3	372.5
		1,038.8	974.3	352.4	500.9
Liabilities					
Current liabilities					
Borrowings	28	(209.8)	(146.5)	(433.2)	(357.8)
Financial liabilities at fair value through profit	24	(2.6)	(2.4)	(0.4)	-
Derivative financial instruments	23	(9.4)	(17.3)	(2.7)	(2.1)
Trade and other payables	26	(342.0)	(286.5)	(57.1)	(6.3)
Current tax liabilities	27	(24.4)	(26.8)	(23.9)	(37.9)
Provisions	32	(38.0)	(40.4)	-	-
		(626.2)	(519.9)	(517.3)	(404.1)
Net current assets		412.6	454.4	(164.9)	96.8
Non-current liabilities					
Borrowings	28	(3,177.0)	(3,116.5)	(711.7)	(848.2)
Other non-current liabilities	29	(140.1)	(180.7)	(8.7)	(53.0)
Financial liabilities at fair value through profit	24	(46.6)	(48.4)	(1.7)	(1.4)
Derivative financial instruments	23	(8.2)	(25.2)	(0.9)	(1.3)
Retirement benefit obligations	30	(49.5)	(68.0)	(3.3)	(4.1)
Deferred tax liabilities	31	(295.6)	(269.6)	-	-
Provisions	32	(181.5)	(173.8)	-	-
		(3,898.5)	(3,882.2)	(726.3)	(908.0)
Net assets		1,639.1	1,509.2	1,941.6	1,830.2
Shareholders' Equity					
Share capital	33	170.8	168.4	170.8	168.4
Share premium account	34	218.8	217.4	218.8	217.4
Capital redemption reserve	35	144.2	144.2	144.2	144.2
Retained earnings and other reserves	36	807.1	684.4	1,111.1	1,005.4
Total shareholders' equity		1,340.9	1,214.4	1,644.9	1,535.4
Non-controlling interests		1.5	-	-	-
Perpetual capital securities	37	296.7	294.8	296.7	294.8
Total equity		1,639.1	1,509.2	1,941.6	1,830.2

The profit for the year attributable to ordinary shareholders' equity dealt within the accounts of the parent Company is £215.1 million (2017 £162.9 million).

The notes on pages 119 to 168 form part of these financial statements.

The financial statements on pages 114 to 168 were approved by the Board of Directors and authorised for issue on 24 May 2018 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 2018

Group	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	Non- controlling interests £m	Perpetual capital securities (note 37) £m	Total equity £m
At 1 April 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	-	(26)	-	-	(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
Profit for the year	-	-	-	200.6	(0.2)	21.5	221.9
Other comprehensive income for the year	-	-	-	34.6	-	-	34.6
Total comprehensive income for the year	-	-	-	235.2	(0.2)	21.5	256.5
<i>Transactions with equity shareholders:</i>							
Dividends paid	-	-	-	(149.5)	-	-	(149.5)
Adjustment for shares issued under the Scrip Dividend Alternative	2.1	(2.1)	-	41.7	-	-	41.7
Adjustment in respect of share-based payments (net of tax)	-	-	-	2.2	-	-	2.2
Issuance of perpetual capital securities	-	-	-	-	-	296.7	296.7
Redemption of perpetual capital securities	-	-	-	(5.2)	-	(294.8)	(300.0)
Distributions to perpetual capital security holders	-	-	-	-	-	(25.3)	(25.3)
Current tax relief on distributions to perpetual capital security holders	-	-	-	-	-	3.8	3.8
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	0.1	0.4	-	(1.7)	-	-	(1.2)
Proceeds from shares issued under the Executive Share Option Scheme	-	-	-	-	-	-	-
Proceeds from shares issued under the Sharesave Scheme	0.2	3.1	-	-	-	-	3.3
Non-controlling interests	-	-	-	-	1.7	-	1.7
Total transactions with equity shareholders	2.4	1.4	-	(112.5)	1.7	(19.6)	(126.6)
At 31 March 2018	170.8	218.8	144.2	807.1	1.5	296.7	1,639.1

The notes on pages 119 to 168 form part of these financial statements.

PENNON GROUP PLC
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Company	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
At 1 April 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
Profit for the year (note 10)	-	-	-	215.1	21.5	236.6
Other comprehensive income for the year	-	-	-	3.6	-	3.6
Total comprehensive income for the year	-	-	-	218.7	21.5	240.2
<i>Transactions with equity shareholders:</i>						
Dividends paid	-	-	-	(149.5)	-	(149.5)
Adjustment for shares issued under the Scrip Dividend Alternative	2.1	(2.1)	-	41.7	-	41.7
Issuance of perpetual capital securities	-	-	-	-	296.7	296.7
Redemption of perpetual capital securities	-	-	-	(5.2)	(294.8)	(300.0)
Distributions to perpetual capital security holders	-	-	-	-	(25.3)	(25.3)
Current tax relief on distributions to perpetual capital security holders	-	-	-	-	3.8	3.8
Adjustment in respect of share-based payments (net of tax)	-	-	-	0.8	-	0.8
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	0.1	0.4	-	(0.8)	-	(0.3)
Proceeds from shares issued under the Executive Share Option Scheme	-	-	-	-	-	-
Proceeds from shares issued under the Sharesave Scheme	0.2	3.1	-	-	-	3.3
Total transactions with equity shareholders	2.4	1.4	-	(113.0)	(19.6)	(128.8)
At 31 March 2018	170.8	218.8	144.2	1,111.1	296.7	1,941.6

The notes on pages 119 to 168 form part of these financial statements.

Cash flow statements

For the year ended 31 March 2018

	Notes	Group		Company	
		2018 £m	2017 £m	2018 £m	2017 £m
Cash flows from operating activities					
Cash generated/(outflow) from operations	38	443.5	431.5	249.4	(159.0)
Interest paid	38	(69.6)	(76.4)	(32.5)	(39.1)
Tax (paid)/received		(21.7)	(36.4)	17.9	(8.4)
Net cash generated/(outflow) from operating activities		352.2	318.7	234.8	(206.5)
Cash flows from investing activities					
Interest received		8.3	14.5	41.2	49.6
Dividends received	45	6.5	4.5	202.3	247.0
Investments in subsidiary undertakings		-	-	(356.6)	-
Loan repayments received from joint ventures		33.3	0.3	-	-
Return of restricted deposits		42.3	-	-	-
Purchase of property, plant and equipment		(390.6)	(354.1)	(0.2)	(0.2)
Purchase of intangible assets		(1.0)	-	-	-
Acquisition of subsidiary undertakings	44	(8.4)	-	-	-
Proceeds from sale of property, plant and equipment		10.6	4.1	-	0.1
Net cash (used in)/received from investing activities		(299.0)	(330.7)	(113.3)	296.5
Cash flows from financing activities					
Proceeds from issuance of ordinary shares		3.9	4.7	3.9	4.7
Proceeds from the issuance of perpetual capital securities		296.7	-	296.7	-
Redemption of 2013 perpetual capital securities		(300.0)	-	(300.0)	-
Purchase of ordinary shares by the Pennon Employee Share Trust		(1.8)	(2.6)	-	-
Return of restricted funds		-	2.7	-	9.7
Proceeds from new borrowing		106.9	130.0	-	-
Repayment of borrowings		(116.0)	(39.0)	(63.9)	-
Finance lease sale and lease back		140.1	60.7	-	-
Finance lease principal repayments		(28.6)	(24.0)	-	-
Disposal of non-controlling interest	44	1.7	-	-	-
Dividends paid		(107.8)	(131.6)	(107.8)	(131.6)
Perpetual capital securities periodic return	37	(19.6)	(20.3)	(19.6)	(20.3)
Net cash used in financing activities		(24.5)	(19.4)	(190.7)	(137.5)
Net increase/(decrease) in cash and cash equivalents					
Cash and cash equivalents at beginning of the year	25	374.3	405.7	372.5	420.0
Cash and cash equivalents at end of the year	25	403.0	374.3	303.3	372.5

The notes on pages 119 to 168 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. Pennon Group's business is 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. Pennon Group is also the majority shareholder of Pennon Water Services Limited, a company providing water and wastewater retail services to non-household customer accounts across Great Britain.

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 104.

The new standards or interpretations which were mandatory for the first time in the year beginning 1 April 2017 did not have a material impact on the net assets or results of the Group.

- IFRS 15 'Revenue from contracts with customers' relates to revenue recognition and establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. The standard will replace IAS 18 'Revenue' and IAS 11 'Construction contracts' and related interpretations. The standard is effective for annual periods beginning on or after 1 January 2018.

The Directors anticipate that the adoption of IFRS 15 on 1 April 2018 will not materially impact reported revenues or net assets. It is anticipated that additional information on the analysis of contract assets and contract liabilities will be disclosed.

- 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.

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 £163 million, see note 41. These predominantly relate to leases of properties occupied by the Group in the course of carrying out its businesses. If the standard had been adopted in the current year (assuming application of the modified retrospective transitional approach permitted by the standard) it is estimated this would have resulted in the Group recognising an asset in use and corresponding lease liability figure in the region of £115 million. This would have resulted in a minimal impact on profit before tax but an estimated increase of around £7 million EBITDA which would be replaced by increased charges for depreciation and finance costs. These impacts are not considered to be material to the Group's net assets or results. Existing borrowing covenants are not impacted by changes in accounting standards.

Other new standards or interpretations in issue, but not yet effective, including 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 customer usage of 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 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. The non-household retail business is a new segment created this period reflecting the services provided by Pennon Water Services following the opening of the non-household water and wastewater retail market to competition on 1 April 2017. 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.

2. Principal accounting policies continued

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 (w).

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.

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.

Notes to the financial statements

continued

2. Principal accounting policies continued

(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 amortisation.

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 through 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.

2. Principal accounting policies continued

(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.

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.

Notes to the financial statements

continued

2. Principal accounting policies continued

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.

3. Financial risk management continued

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 2018					
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	181.5	129.1	426.2	1,144.9	1,881.7
Interest payments on borrowings	57.5	53.7	147.9	689.1	948.2
Finance lease liabilities including interest	52.1	87.1	223.7	2,121.7	2,484.6
Trade and other payables	342.0	-	-	-	342.0
Guarantees	185.1	-	-	-	185.1
Derivative financial liabilities					
Derivative contracts – net payments/(receipts)	4.1	2.4	(11.3)	(71.1)	(75.9)
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)	(63.3)
Company					
31 March 2018					
Non-derivative financial liabilities					
Borrowings excluding intercompany borrowings	149.6	102.1	260.6	349.0	861.3
Interest payments on borrowings	31.4	27.4	69.8	76.8	205.4
Trade and other payables	57.1	-	-	-	57.1
Guarantees	734.9	-	-	-	734.9
Derivative financial liabilities					
Derivative contracts – net payments	0.7	-	-	-	0.7
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	74.3.4	-	-	-	74.3.4
Derivative financial liabilities					
Derivative contracts – net payments	1.3	1.1	-	-	2.4

No liability is expected to arise in respect of the guarantees noted above. Guarantees are analysed in note 42.

ii) Market risk

The Group has a policy of maintaining at least 50% of interest-bearing liabilities at fixed rates. The Group uses a combination of fixed rate and index-linked borrowings and fixed rate interest swaps as cash flow hedges of future variable interest payments to achieve this policy. At the year-end 62% (2017 69%) 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% (2017 20%) 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 2018 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 £1.3 million (2017 £0.3 million), for the equity sensitivity fair value, with derivative impacts excluded.

For 2018 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 £2.0 million (2017 £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.

Notes to the financial statements

continued

3. Financial risk management continued

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 2018 the Group had cash and facilities, including restricted funds, of £1.2 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:

	2018 £m	2017 £m
Net borrowings (note 39)	2,801.5	2,664.9
Total equity	1,639.1	1,509.2
Total capital	4,440.6	4,174.1
Gearing ratio	63.1%	63.8%

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	
	2018 £m	2017 £m
Regulatory Capital Value	3,431.2	3,290.6
Net borrowings	2,068.1	2,033.8
Net borrowings/Regulatory Capital Value	60.3%	61.8%

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.

Viridor assume an aftercare period of 60 years in calculating provision values. This is considered reasonable by management, is comparable to peers in the waste business and is consistent with Environment Agency bond periods.

The impact of a 0.1% change in discount rate is estimated to be in the region of £3 million.

As at 31 March 2018 the Group's environmental and landfill restoration provisions were £191.9 million (2017 £183.8 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 2018 these assets had a net book value of £18.4 million (2017 £14.3 million) (note 17).

Retirement benefit obligations

The Group operates defined benefit pension schemes for which actuarial valuations are carried out as determined by the trustees at intervals of not more than three years. The last such valuation of the main scheme was as at 31 March 2016.

The pension cost and liabilities under IAS 19 are assessed in accordance with Directors' best estimates using the advice of an independent qualified actuary and assumptions in the latest actuarial valuation. The assumptions are based on member data supplied to the actuary and market observations for interest rates and inflation, supplemented by discussions between the actuary and management. The mortality assumption uses a scheme-specific calculation based on CMI 2016 actuarial tables with an allowance for future longevity improvement. The principal assumptions used to measure schemes' liabilities, sensitivities to changes in those assumptions and future funding obligations are set out in note 30.

Taxation

The Group's current tax provision of £24.4 million, reduced from £26.8 million in 2016/17, includes £12.6 million related to prior year tax items.

The Group continues to have a small number of ongoing uncertain tax items primarily relating to the interpretation of tax legislation regarding different tax aspects of its energy recovery facilities. This is part of the normal course of business and the Group has paid in full the tax HMRC interpret as due, and therefore would benefit by a cash refund of up to £18 million (2016/17 £20 million) should these tax items be concluded in the Group's favour. The Group is working towards resolution of these matters with HMRC.

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 £234.1 million (2017 £217.6 million) and other intangible assets of £69.2 million (2017 £61.3 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. Pennon Water Services raises bills and recognises revenue in accordance with its contracts with customers and in line with the limits established for the non-household periodic price-setting process where applicable. 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 £61.5 million (2017 £77.7 million) for South West Water and £20.2 million for Pennon Water Services. Each year a review of the actual amounts billed in comparison with the metered accrual recognised at the previous year end is undertaken to ensure that the methodology continues to be supported by historic experience.

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 £53.4 million (2017 £42.8 million).

Notes to the financial statements

continued

4. Critical accounting judgements and estimates continued

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 2018 the Group's current trade receivables were £325.0 million (2017 £321.6 million), against which £104.3 million (2017 £98.1 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 2017/18 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.

Greater Manchester contract reset

Following the renegotiation of the Greater Manchester contract and sale of the joint venture Viridor Laing Greater Manchester to the Greater Manchester Waste Disposal Authority (see notes 6 and 20) judgement has been required to ensure all the various economic aspects of the reset have been fully considered in concluding the appropriate accounting treatment. In particular in arriving at the amount of profit to be recognised in respect of the retained TPSCo joint venture (a non-underlying profit of £22.5 million, as described in note 6), it was necessary for management to consider fair values attributed to all aspects of the transaction.

Glasgow Recycling and Renewable Energy Centre (GRECC)

Completion of the construction of this facility has required a higher level of remediation expenditure than originally envisaged. Cumulative spend of £238 million has been incurred to 31 March 2018 which is higher than the original target of £155 million. Viridor is contractually entitled to recover incremental costs from the original principal contractor, Interserve, under certain circumstances. The Group believes these circumstances have been met and discussions with Interserve are ongoing with regard to the contractual settlement. At 31 March 2018 a receivable of £68.7 million has been recognised. In accordance with IFRIC 12 service concession arrangements, a financial asset of £140.6 million and an intangible asset of £67.6 million have been recognised (including rolled up finance income and capitalised interest), with no operating profit on construction having been taken to date. While there are further possible recoveries that are contingent on future events, these are not currently recognised. The ultimate agreement of the contractual amount due to the Group from the original principal contractor, including the nature of the receipts and the recoverability of such agreed amounts under the contract, could result in revisions to the receivable and the amounts recorded for the financial asset and intangible assets, including the allocation between the two amounts, which could then impact the margins recognised on this contract over the life of the project to 2043. Internal assessments have been corroborated by legal advice in arriving at appropriate amounts to be recognised on the balance sheet.

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. The non-household retail business is a new segment created this year reflecting the services provided by Pennon Water Services following the opening of the non-household water and wastewater retail market to competition on 1 April 2017. 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.

Comparative information has been re-presented during the year to reflect the opening of the non-household water and wastewater retail market to competition. Comparative results for the non-household retail segment were previously recognised in the water segment.

5. Segmental information continued

	2018 £m	2017 £m
Revenue		
Water	571.3	555.3
Waste management	788.9	793.5
Non-household retail	165.9	128.6
Other	13.8	12.8
Less intra-segment trading*	(143.7)	(137.1)
	1,396.2	1,353.1
Segment result		
Operating profit before depreciation, amortisation and non-underlying items (EBITDA)		
Water	360.9	347.6
Waste management	150.2	138.3
Non-household retail	1.0	1.5
Other	(2.5)	(1.4)
	509.6	486.0
Operating profit before non-underlying items		
Water	247.8	233.9
Waste management	78.6	71.1
Non-household retail	0.4	1.5
Other	(2.9)	(1.9)
	323.9	304.6
Profit before tax and non-underlying items		
Water	180.5	172.4
Waste management	70.8	60.4
Non-household retail	(1.1)	1.5
Other	8.6	15.7
	258.8	250.0
Profit before tax		
Water	178.1	185.9
Waste management	77.3	50.2
Non-household retail	(1.1)	1.5
Other	8.6	(27.1)
	262.9	210.5

* 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.

	Water £m	Waste management £m	Non- household retail £m	Other £m	Eliminations £m	Group £m
Balance sheet						
31 March 2018						
Assets (excluding investments in joint ventures)	3,513.2	2,254.2	66.6	1,506.9	(1,199.3)	6,141.6
Investments in joint ventures	-	22.8	-	-	-	22.8
Total assets	3,513.2	2,277.0	66.6	1,506.9	(1,199.3)	6,164.4
Liabilities	(2,721.9)	(1,512.4)	(59.1)	(1,431.2)	1,199.3	(4,525.3)
Net assets	791.3	764.6	7.5	75.7	-	1,639.1
31 March 2017						
Assets (excluding investments in joint ventures)	3,461.4	2,099.9	33.6	1,856.8	(1,540.5)	5,911.2
Investments in joint ventures	-	0.1	-	-	-	0.1
Total assets	3,461.4	2,100.0	33.6	1,856.8	(1,540.5)	5,911.3
Liabilities	(2,641.6)	(1,697.4)	(25.6)	(1,578.0)	1,540.5	(4,402.1)
Net assets	819.8	402.6	8.0	278.8	-	1,509.2

Segment liabilities of the water and waste management segments comprise of operating liabilities and borrowings. The other segment includes company only assets and liabilities as well as Group taxation liabilities and should be considered in conjunction with the eliminations column.

Notes to the financial statements

continued

5. Segmental information continued

	Notes	Water £m	Non- household retail £m	Waste management £m	Other £m	Group £m
Other information						
31 March 2018						
Amortisation of other intangible assets	7	0.5	0.1	3.0	-	3.6
Capital expenditure	17	181.6	3.5	203.7	0.2	389.0
Depreciation	7	112.9	0.6	68.6	0.4	182.5
Finance income (before non-underlying items)	8	1.2	-	21.8	1.2	24.2
Finance costs (before non-underlying items)	8	68.4	1.5	14.8	14.0	98.7
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	8	62.3	-	12.3	20.5	95.1

	2018 £m	2017 £m
Revenue		
United Kingdom	1,338.0	1,287.6
Rest of European Union	12.3	10.3
China	31.0	45.1
Rest of World	11.7	10.1
	1,393.0	1,353.1

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. The presentation of results is consistent with internal performance monitoring.

	Notes	2018 £m	2017 £m
Revenue			
Construction contract settlement ^(1a)	20	3.2	-
Operating costs			
Restructuring costs ⁽²⁾	17, 32	-	(10.7)
Earnings before interest, tax, depreciation and amortisation			
		3.2	(10.7)
Remeasurement of fair value movement in derivatives ⁽³⁾	8	(2.4)	16.0
Write-down of joint venture shareholder loans ^(1b)	20	(19.2)	-
Refinancing of joint venture arrangement ^(1c)	20	22.5	-
Unwind of synthetic derivative ⁽⁴⁾		-	(44.8)
Deferred tax change in rate ⁽⁵⁾		-	21.3
Tax credit arising on non-underlying items	9	3.4	7.1
Net non-underlying credit/(charge)		7.5	(11.1)

(1) On reset of the contracts associated with the Greater Manchester Waste Disposal Authority (GMWDA) an overall net credit before tax of £6.5 million has been recognised as follows:

- A net amount of £3.2 million has been recognised in revenue following the settlement of all outstanding claims relating to the construction of assets.
- On reset of the contracts associated with GMWDA ownership of Viridor Laing Holdings Limited passed to the GMWDA. On transfer £23.5 million of Viridor's shareholder loans were repaid, resulting in the write down of the remaining financial asset of £19.2 million.
- On reset of the contracts associated with GMWDA repayment of external bank debt in our joint venture, Ineos Runcorn TPSCo Limited, was financed by GMWDA. This change in cash flows resulted in the recognition of income in this joint venture, with an amount deferred relating to a lower ongoing gate fee. The overall share of profit after tax related to the reset is £22.5 million, which has contributed to an increase in investments in joint ventures recognised on the balance sheet to £22.8 million (31 March 2017 £0.1 million).

These items are considered non-underlying due to their size and non-recurring nature.

6. Non-underlying items continued

- (2) In the prior year a one-off charge of £10.7 million was made relating to restructuring costs associated with a Group-wide Shared Services Review. The £10.7 million charge consisted 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 was considered non-underlying due to its size and non-recurring nature.
- (3) In the year a charge of £2.4 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).
- (4) This relates to the unwind of a synthetic derivative in place from 2011 until it was unwound in February 2017 (the Peninsula MB derivative as set out in Note 6 of the Annual Report and Accounts 2017).
- (5) Last year 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 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 were non-underlying due to being dependent on UK tax law and due to their size.

7. Operating costs

	Notes	2018 £m	2017 £m
Employment costs before non-underlying items	13	192.9	179.7
Raw materials and consumables		108.7	115.8
Other operating expenses before non-underlying items include:			
Profit on disposal of property, plant and equipment		(2.5)	(7.5)
Operating lease rentals payable:			
- Plant and machinery		17.2	17.2
- Property		8.9	8.8
Research and development expenditure		0.1	0.2
Trade receivables impairment	22	7.5	7.4
Depreciation of property, plant and equipment:			
- Owned assets		139.4	136.5
- Under finance leases		43.1	41.7
Amortisation of other intangible assets	16	3.6	3.2

Operating costs in the prior year include a charge of £10.7 million relating to non-underlying items, as detailed in note 6.

Fees payable to the Company's auditors in the year were:

	2018 £000	2017 £000
Fees payable to the Company's auditors and its associates for the audit of parent Company and consolidated financial statements	91	91
Fees payable to the Company's auditors and its associates for other services:		
The audit of Company's subsidiaries	632	583
Audit related assurance services	50	50
Other non-audit services	111	77
Total fees	884	801
Fees payable to the Company's auditors in respect of Pennon Group pension schemes:		
Audit	37	32

Expenses reimbursed to the auditors in relation to the audit of the Group were £57,000 (2017 £51,000).

A description of the work of the Audit Committee is set out in its report on pages 73 to 76 which includes an explanation of how the auditors' objectivity and independence are safeguarded when non-audit services are provided by the auditors' firm.

Notes to the financial statements

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8. Net finance costs

Notes	2018			2017		
	Finance cost £m	Finance income £m	Total £m	Finance cost £m	Finance income £m	Total £m
Cost of servicing debt						
Bank borrowing and overdrafts	(48.6)	-	(48.6)	(49.4)	-	(49.4)
Interest element of finance lease rentals	(34.4)	-	(34.4)	(31.9)	-	(31.9)
Other finance costs	(3.9)	-	(3.9)	(3.5)	-	(3.5)
Interest receivable	-	2.5	2.5	-	3.2	3.2
Interest receivable on shareholder loans to joint ventures	-	7.9	7.9	-	10.2	10.2
	(86.9)	10.4	(76.5)	(84.8)	13.4	(71.4)
Notional interest						
Interest receivable on service concession arrangements	-	13.8	13.8	-	16.1	16.1
Retirement benefit obligations	30 (1.6)	-	(1.6)	(1.2)	-	(1.2)
Unwinding of discounts in provisions	32 (10.2)	-	(10.2)	(9.1)	-	(9.1)
	(11.8)	13.8	2.0	(10.3)	16.1	5.8
Net gains on derivative financial instruments arising from the combination of non-derivative instruments	-	-	-	-	6.8	6.8
Net finance cost before non-underlying items	(98.7)	24.2	(74.5)	(95.1)	36.3	(58.8)
Non-underlying items						
Fair value remeasurement of non-designated derivative financial instruments providing commercial hedges	(2.4)	-	(2.4)	-	16.0	16.0
Write-down of joint venture shareholder loans	6 (19.2)	-	(19.2)	-	-	-
Unwind of synthetic derivative	6 -	-	-	(44.8)	-	(44.8)
Net finance cost after non-underlying items	(120.3)	24.2	(96.1)	(139.9)	52.3	(87.6)

In addition to the above, finance costs of £17.0 million (2017 £12.9 million) have been capitalised on qualifying assets included in property, plant and equipment and other intangible assets.

9. Taxation

Notes	Before non-underlying items 2018 £m	Non-underlying items (note 6) 2018 £m	Total 2018 £m	Before non-underlying items 2017 £m	Non-underlying items (note 6) 2017 £m	Total 2017 £m
Analysis of charge in year						
Current tax charge	26.1	(3.0)	23.1	39.5	(9.4)	30.1
Deferred tax – other	18.3	(0.4)	17.9	18.9	2.3	21.2
Deferred tax arising on change of rate of corporation tax	-	-	-	-	(21.3)	(21.3)
Total deferred tax charge/(credit)	31 18.3	(0.4)	17.9	18.9	(19.0)	(0.1)
Tax charge for year	44.4	(3.4)	41.0	58.4	(28.4)	30.0

UK corporation tax is calculated at 19% (2017 20%) of the estimated assessable profit for the year.

UK corporation tax is stated after a credit relating to prior year current tax of £36 million (2017 credit of £18 million) and a prior year deferred tax credit of £2.4 million (2017 charge of £1.1 million).

The 2017 deferred tax credit includes a credit of £21.3 million reflecting a reduction in the rate of UK corporation tax.

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 of 19% (2017 20%) as follows:

	2018 £m	2017 £m
Reconciliation of total tax charge		
Profit before tax	262.9	210.5
Profit before tax multiplied by the standard rate of UK corporation tax of 19% (2017 20%)	49.9	42.1
Effects of:		
Expenses not deductible for tax purposes	0.3	(1.3)
Financial transaction deemed ineligible	-	10.7
Joint ventures profits not taxed	(6.1)	(0.9)
Change in rate of corporation tax	-	(21.3)
Adjustments to tax charge in respect of prior years	(6.0)	(0.7)
Depreciation charged on non-qualifying assets	1.5	1.9
Other	1.4	(0.5)
Tax charge for year	41.0	30.0

	2018 £m	2017 £m
Reconciliation of current tax charge		
Profit before tax	262.9	210.5
Profit before tax multiplied by the standard rate of UK corporation tax of 19% (2017 20%)	49.9	42.1
Relief for capital allowances in place of depreciation	(49.5)	(48.5)
Disallowance of depreciation charged in the accounts	31.2	31.6
Financial transactions deemed ineligible	-	10.7
Other timing differences	1.6	(3.1)
Adjustments to tax charge in respect of prior years	(3.6)	(1.8)
Joint venture profits not taxed	(6.1)	(0.9)
Expenses not deductible for tax purposes	0.3	(1.3)
Depreciation charged on non-qualifying assets	1.5	1.9
Relief for capitalised interest and foreign exchange gains/losses	(2.2)	(0.5)
Research and Development Expenditure credit	-	(0.1)
Current tax charge for year	23.1	30.1

The Group's current tax charge is lower than the UK headline tax rate of 19%, primarily due to the availability of capital allowances. Capital allowances provide tax relief when a business incurs expenditure on qualifying capital items such as plant and machinery used by the business. As an infrastructure business, these allowances help the Group to plan major investment and consequentially to maintain lower customers bills, as corporation tax relief is given against the investments made. As noted in the deferred tax note (note 31), the rate of UK corporation tax will reduce to 17% from April 2020.

Joint Venture profits are not subject to any additional tax within the Group as these are included on a post tax basis already, as the Joint Venture entity is subject to tax itself.

In addition to the amounts recognised in the income statement the following tax charges and credits were also recognised:

	2018 £m	2017 £m
Amounts recognised directly in other comprehensive income		
Deferred tax charge/(credit) on defined benefit pension schemes	4.2	(3.3)
Deferred tax charge on cash flow hedges	3.4	1.3
Amounts recognised directly in equity		
Deferred tax charge/(credit) on share-based payments	0.4	(0.3)
Current tax credit on perpetual capital securities periodic return	(3.8)	(4.1)

10. Profit of the Parent Company

	2018 £m	2017 £m
Profit attributable to ordinary shareholders' equity dealt within the accounts of the parent company	215.1	162.9

As permitted by Section 408 of the Companies Act 2006 no income statement or statement of comprehensive income is presented for the Company.

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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, the Long-term Incentive Plan and the deferred shares element of the Annual Incentive Bonus Plan, based on performance criteria for the vesting of the awards.

The weighted average number of shares and earnings used in the calculations were:

	2018	2017
Number of shares (millions)		
For basic earnings per share	417.9	413.0
Effect of dilutive potential ordinary shares from share options	1.5	1.9
For diluted earnings per share	419.4	414.9

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. Perpetual capital returns are proportionately adjusted to allow a more useful comparison in the year as the full return is accrued at 31 March 2018 but not payable until May. Earnings per share have been calculated as follows:

	2018			2017		
	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	200.6	48.0	47.8	164.3	39.8	39.6
Deferred tax charge before non-underlying items	18.3	4.4	4.4	18.9	4.5	4.6
Non-underlying items (net of tax)	(7.5)	(1.8)	(1.8)	11.1	2.7	2.6
Proportional adjustment on Perpetual capital returns	1.3	0.3	0.3	–	–	–
Adjusted earnings	212.7	50.9	50.7	194.3	47.0	46.8

12. Dividends

	2018 £m	2017 £m
Amounts recognised as distributions to ordinary equity holders in the year		
Interim dividend paid for the year ended 31 March 2017: 11.09p (2016 10.46p) per share	45.9	43.1
Final dividend paid for the year ended 31 March 2017: 24.87p (2016 23.12p) per share	103.6	95.4
	149.5	138.5
Proposed dividends		
Proposed interim dividend for the year ended 31 March 2018: 11.97p per share	50.2	
Proposed final dividend for the year ended 31 March 2018: 26.62p per share	111.8	
	162.0	

The proposed interim and final dividends have not been included as liabilities in these financial statements.

The proposed interim dividend for 2018 was paid on 4 April 2018 and the proposed final dividend is subject to approval by shareholders at the Annual General Meeting.

13. Employment costs

	Notes	2018 £m	2017 £m
Wages and salaries		170.6	157.1
Social security costs		17.4	16.6
Pension costs	30	20.7	18.8
Share-based payments	33	2.8	2.9
Non-underlying items	6, 30	-	1.1
Total employment costs		211.5	196.5
Charged:			
Employment costs (excluding non-underlying items) – consolidated income statement		192.9	179.7
Non-underlying items – consolidated income statement	6	-	1.1
Capital schemes – property, plant and equipment		18.6	15.7
Total employment costs		211.5	196.5

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.

	2018	2017
Employees (average full time equivalent number)		
The average monthly number of employees (including Executive Directors) was:		
Water	1,575	1,589
Waste management	3,285	3,153
Non-household retail	81	-
Other	73	57
Group totals	5,014	4,799

The total number of employees at 31 March 2018 was 5,190 (2017 4,788).

14. Directors' emoluments

	2018 £000	2017 £000
Executive Directors:		
Salary	914	1,205
Performance-related bonus paid or payable	398	381
Share-based payments	667	421
Other emoluments, including payments in lieu of pension provision	298	312
Non-Executive Directors	477	471
	2,754	2,790

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 £nil (2017 £102,000). Total gains made by Directors on the exercise of share options were £nil (2017 £17,000).

Total emoluments include £nil (2017 £476,000) payable to Directors for services as directors of subsidiary undertakings.

At 31 March 2018 one Director (2017 one) is accruing retirement benefits under defined benefit pension schemes in respect of which the Group contributed £28,000 (2017 £35,000).

At 31 March 2018 no Director (2017 no) is a member of the Group's defined contribution pension scheme in respect of which the Group contributed £nil (2017 £40,000).

At 31 March 2018 two Directors received payments in lieu of pension provision (2017 two).

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 84 to 101.

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15. Goodwill

	£m
Cost:	
At 1 April 2016	385.0
At 31 March 2017	385.0
At 31 March 2018	385.0
Carrying amount:	
At 1 April 2016	385.0
At 31 March 2017	385.0
At 31 March 2018	385.0

Goodwill acquired in a business combination is allocated at acquisition to the cash generating unit (CGU) expected to benefit from that business combination. £342.7 million of the goodwill balance is allocated to the waste management business, with the remaining £42.3 million allocated to the water business, representing the lowest levels at which goodwill is monitored and tested.

Impairment testing of goodwill

The Group tests goodwill for impairment annually, or more frequently if there are any indications that impairment may have arisen.

The recoverable amount of the water business segment, for which goodwill was recognised on acquisition of Bournemouth Water in 2015, 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 7-10% 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.

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.

16. Other intangible assets

	Service concession arrangements £m	Customer contracts £m	Patents £m	Other £m	Total £m
Acquired intangible assets					
Cost:					
At 1 April 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
Additions	8.1	-	-	1.0	9.1
At 31 March 2018	69.6	34.3	0.2	3.6	107.7
Accumulated amortisation:					
At 1 April 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
Charge for year	0.2	2.8	-	0.6	3.6
At 31 March 2018	0.4	32.7	0.2	1.8	35.1
Carrying amount:					
At 1 April 2016	55.0	6.8	-	2.0	63.8
At 31 March 2017	61.3	4.4	-	1.4	67.1
At 31 March 2018	69.2	1.6	-	1.8	72.6

Service concession arrangements, once available for use, are amortised over the useful life of each contract. The average remaining life is 22 years (2017 23 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 one year (2017 two years).

Patents are amortised over their estimated useful lives which at acquisition was 13 years. The average remaining life is nil years (2017 nil years).

Other, including computer software, is amortised over the useful life of the assets which at acquisition was five years. The average remaining life is five years (2017 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 £2.3 million (2017 £2.1 million) have been capitalised on qualifying assets, at an average borrowing rate of 3.7% (2017 3.5%).

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17. Property, plant and equipment

	Land and buildings £m	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant, vehicles and computers £m	Landfill restoration £m	Construction in progress £m	Total £m
Group							
Cost:							
At 1 April 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	470	71	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
Additions	12.3	13.2	1.8	45.4	11.1	305.2	389.0
Assets adopted at fair value	-	8.0	-	-	-	-	8.0
Grants and contributions	-	(2.2)	-	-	-	-	(2.2)
Disposals	(0.4)	(1.2)	-	(9.9)	-	-	(11.5)
Transfers/reclassifications	3.7	21.9	11.1	85.4	-	(122.1)	-
At 31 March 2018	555.0	1,894.5	719.3	2,855.1	82.8	555.4	6,662.1
Accumulated depreciation:							
At 1 April 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
Charge for year	17.2	23.0	13.4	125.3	7.0	-	185.9
Disposals	(0.2)	(1.2)	-	(8.6)	-	-	(10.0)
At 31 March 2018	401.7	268.6	253.4	1,363.4	64.4	-	2,351.5
Net book value:							
At 1 April 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
At 31 March 2018	153.3	1,625.9	465.9	1,491.7	18.4	555.4	4,310.6

Of the total depreciation charge of £185.9 million (2017 £181.3 million), £1.5 million (2017 £1.6 million) has been charged to capital projects, £1.9 million (2017 £1.5 million) has been offset by deferred income and £182.5 million (2017 £178.2 million) has been charged against profits. Asset lives and residual values are reviewed annually. During the year borrowing costs of £14.7 million (2017 £10.8 million) have been capitalised on qualifying assets, at an average borrowing rate of 3.7% (2017 3.5%).

Groups of assets forming cash generating units are reviewed for indicators of impairment. No indicators of impairment were identified during the year.

Asset lives are reviewed annually. No significant changes were required in 2017/18.

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 2017	409.0	436.7	574.8	0.2	1,420.7
At 31 March 2018	416.9	463.7	673.7	0.2	1,554.5
Accumulated depreciation:					
At 31 March 2017	58.2	111.6	276.0	-	445.8
At 31 March 2018	63.3	119.4	305.3	-	488.0
Net book amount:					
At 31 March 2017	350.8	325.1	298.8	0.2	974.9
At 31 March 2018	353.6	344.3	368.4	0.2	1,066.5

Company	Fixed and mobile plant, vehicles and computers £m
Cost:	
At 1 April 2016	0.3
Additions	0.2
Disposals	(0.2)
At 31 March 2017	0.3
Additions	0.1
At 31 March 2018	0.4
Accumulated depreciation:	
At 1 April 2016	0.2
Charge for year	-
Disposals	(0.1)
At 31 March 2017	0.1
Charge for year	0.1
At 31 March 2018	0.2
Net book value:	
At 1 April 2016	0.1
At 31 March 2017	0.2
At 31 March 2018	0.2

Asset lives and residual values are reviewed annually.

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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 2018							
Financial assets							
Trade receivables	22	-	-	-	-	220.7	220.7
Other receivables	19,22	-	-	-	266.6	-	266.6
Derivative financial instruments	23	4.1	7.0	72.3	-	-	83.4
Cash and cash deposits	25	-	-	-	585.3	-	585.3
Total		4.1	7.0	72.3	851.9	220.7	1,156.0
Financial liabilities							
Borrowings	28	-	-	-	(3,386.8)	-	(3,386.8)
Derivative financial instruments	23	-	(16.7)	(0.9)	-	-	(17.6)
Trade payables	26	-	-	-	-	(98.2)	(98.2)
Other payables	26,29	-	-	-	-	(48.0)	(48.0)
Total		-	(16.7)	(0.9)	(3,386.8)	(146.2)	(3,550.6)
31 March 2017							
Financial assets:							
Trade receivables	22	-	-	-	-	223.5	223.5
Other receivables	19,22	-	-	-	314.3	-	314.3
Derivative financial instruments	23	2.8	6.2	78.7	-	-	87.7
Cash and cash deposits	25	-	-	-	598.1	-	598.1
Total		2.8	6.2	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)
Company							
31 March 2018							
Financial assets							
Amounts owed by subsidiaries	19,22	-	-	-	886.9	-	886.9
Other receivables	22	-	-	-	0.3	-	0.3
Derivative financial instruments	23	4.1	6.5	-	-	-	10.6
Cash and cash deposits	25	-	-	-	303.3	-	303.3
Total		4.1	6.5	-	1,190.5	-	1,201.1
Financial liabilities							
Amounts due to subsidiaries	26	-	-	-	(5.7)	-	(5.7)
Borrowings	28	-	-	-	(1,144.9)	-	(1,144.9)
Derivative financial instruments	23	-	(3.6)	-	-	-	(3.6)
Trade payables	26	-	-	-	-	(0.1)	(0.1)
Other payables	26	-	-	-	-	(44.3)	(44.3)
Total		-	(3.6)	-	(1,150.6)	(44.4)	(1,198.6)
31 March 2017							
Financial assets:							
Amounts owed by subsidiaries	19,22	-	-	-	1,137.7	-	1,137.7
Other receivables	22	-	-	-	0.4	-	0.4
Derivative financial instruments	23	2.9	1.3	-	-	-	4.2
Cash and cash deposits	25	-	-	-	372.5	-	372.5
Total		2.9	1.3	-	1,510.6	-	1,514.8
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)

19. Other non-current assets

Non-current receivables

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Amounts owed by subsidiary undertakings	-	-	846.0	1,011.6
Amounts owed by related parties (note 45)	39.4	87.2	-	-
Service concession arrangements	222.9	210.1	-	-
Other receivables	1.2	10.7	-	-
	263.5	308.0	846.0	1,011.6

Non-current receivables were due:

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Between 1 and 2 years	12.9	19.4	35.5	85.8
Over 2 years and less than 5 years	34.9	23.7	108.1	269.9
Over 5 years	215.7	264.9	702.4	655.9
	263.5	308.0	846.0	1,011.6

The fair values of non-current receivables were:

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Amounts owed by subsidiary undertakings	-	-	909.5	1,115.7
Amounts owed by related parties	70.6	156.9	-	-
Service concession arrangements	222.9	210.1	-	-
Other receivables	1.2	10.7	-	-
	294.7	377.7	909.5	1,115.7

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 24 years. The assets revert to the local authority at the end of the contract. At 31 March 2018 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 2.5% (2017 2.25%). 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 12.6% (2017 12.5%).

Other receivables include site development and pre-contract costs of £0.7 million (2017 £4.1 million).

A significant proportion of the non-current asset balances are 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 2016	1,628.3
Additions	100.0
Disposals	(104.1)
At 31 March 2017	1,624.2
Additions	356.7
Disposals	(0.1)
At 31 March 2018	1,980.8

On 1 April 2017 the Company acquired 2,799,900 ordinary shares of £1 in Pennon Water Services Limited at par, having previously acquired 100 ordinary shares of £1 in 2015. On the same date Pennon Water Services Limited issued 700,000 shares to South Staffordshire Water Plc, resulting in the Company becoming 80% majority shareholder in Pennon Water Services Limited. On 29 March 2018 the Company acquired an additional 3,917,436 ordinary shares of £1 at par, with South Staffordshire Water Plc acquiring a further 979,359 ordinary shares of £1.

On 29 March 2018, in settlement of intercompany loan balances owed by Viridor Limited to the Company, the Company subscribed for an additional £350 million of new share capital in Viridor Limited.

The disposal during the year is related to the unwind of the PMB synthetic derivative in the prior year (described in full in note 6 in the 2017 Annual Report and Accounts). Peninsula MB Limited was put into liquidation during the year.

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20. Investments continued

Joint ventures

	Shares £m
Group	
At 1 April 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
Share of post-tax profit – underlying	9.4
Share of post-tax profit – non-underlying	22.5
Share of other comprehensive charges	(2.7)
Disposals	–
Dividends received	(6.5)
At 31 March 2018	22.8

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 associate undertakings are set out in note 40.

As part of the reset of the contracts associated with the Greater Manchester Disposal Authority (GMWDA) the Group disposed of its interest in Viridor Laing (Greater Manchester) Holdings Limited during the year. Full details of the transaction are given in Note 6.

The Group's joint venture 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
INEOS Runcorn (TPS) Holdings Limited ⁽²⁾	England	20	Equity

(1) Lakeside Energy from Waste Holdings Limited provides energy recovery facility services.

(2) 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 venture and associate:

Summarised balance sheet

	2018		2017		
	Lakeside Energy from Waste 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	16.1	15.5	13.5	63.2	40.0
Other current assets	8.6	10.0	10.5	4.2	6.7
Total current assets	24.7	25.5	24.0	67.4	46.7
Borrowings	–	–	–	–	–
Other current liabilities	(6.5)	(8.6)	(4.6)	(35.9)	(13.8)
Total current liabilities	(6.5)	(8.6)	(4.6)	(35.9)	(13.8)
Non-current					
Assets	109.8	270.3	117.7	303.9	283.5
Borrowings	(95.5)	(86.9)	(105.5)	(321.9)	(319.7)
Other liabilities	(28.4)	(145.1)	(32.9)	(48.4)	(44.2)
Total non-current liabilities	(123.9)	(232.0)	(138.4)	(370.3)	(363.9)
Net assets/(liabilities)	4.1	55.2	(1.3)	(34.9)	(47.5)
Net debt	(79.4)	(71.4)	(92.0)	(258.7)	(279.7)
Associated shareholder loans	16.3	86.9	17.1	80.3	100.9
Net (debt)/funds (excluding shareholder loans)	(63.1)	15.5	(74.9)	(178.4)	(178.8)

20. Investments continued

Summarised statement of comprehensive income

	2018			2017		
	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	49.2	85.3	53.7	46.8	145.5	59.4
EBITDA	33.7	3.6	38.7	29.4	6.3	40.2
Depreciation and amortisation	(7.9)	(0.6)	(12.1)	(8.1)	(1.3)	(12.4)
Non-underlying credit (see note 6)	-	-	60.0	-	-	-
Interest receivable on service concessions	-	11.3	-	-	22.5	-
Other net interest charge	(7.5)	(14.5)	(20.3)	(8.2)	(27.5)	(29.7)
Pre-tax profit/(loss)	18.3	(0.2)	66.3	131	-	(1.9)
Income tax (expense)/income	(3.8)	0.1	(0.3)	(2.2)	(2.5)	1.9
Post-tax profit/(loss)	14.5	(0.1)	66.0	10.9	(2.5)	-
Other comprehensive income	3.9	-	36.7	6.0	8.0	8.1
Total comprehensive income	18.4	(0.1)	102.7	16.9	5.5	8.1
Dividends paid by joint venture	(13.0)	-	-	(9.0)	-	-

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. The current year information for Viridor Laing (Greater Manchester) Holdings Limited covers the period from the start of the year to date of disposal.

Reconciliation of summarised financial information

Reconciliation of the summarised financial information presented to the carrying amount of its interest in the joint venture/associate.

	2018			2017		
	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	(1.3)	(34.9)	(47.5)	(9.2)	(40.4)	(55.6)
Profit/(loss) for the year	14.5	-	66.0	10.9	(2.5)	-
Other comprehensive income/(loss)	3.9	-	36.7	6.0	8.0	8.1
Dividends paid	(13.0)	-	-	(9.0)	-	-
Disposal	-	34.9	-	-	-	-
Closing net assets	4.1	-	55.2	(1.3)	(34.9)	(47.5)
Interest in joint venture	2.1	-	20.7	(0.7)	(17.4)	(17.8)
Share of net liabilities not recognised	-	-	-	0.8	17.4	17.8
Carrying value	2.1	-	20.7	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	
	2018 £m	2017 £m	2018 £m	2017 £m
Raw materials and consumables	24.6	21.3	-	-

Notes to the financial statements

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22. Trade and other receivables – current

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Trade receivables	325.0	321.6	-	-
Less: provision for impairment of receivables	(104.3)	(98.1)	-	-
Net trade receivables	220.7	223.5	-	-
Amounts owed by related parties (note 45)	4.3	17.0	-	-
Amounts owed by subsidiary undertakings	-	-	41.0	126.1
Other receivables	4.1	15.6	0.3	0.4
Prepayments and accrued income	186.9	84.7	1.4	0.8
	416.0	340.8	42.7	127.3

Trade receivables include accrued income relating to customers with water budget plans.

In the current year prepayments and accrued income include contractual compensation amounts due totalling £68.7 million related to additional costs incurred in the construction of the Glasgow Recycling and Renewable Energy Centre. A full credit risk appraisal has been carried out on this receivable.

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:

	2018 £m	2017 £m
Group		
Past due 1 – 30 days	55.6	34.1
Past due 31 – 120 days	27.8	26.6
More than 120 days	161.3	148.2

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:

	2018 £m	2017 £m
At 1 April	98.1	95.6
Associated with acquisition of trade receivables (non-household market)	3.0	-
Provision for receivables impairment	7.5	7.4
Receivables written off during the year as uncollectable	(4.3)	(4.9)
At 31 March	104.3	98.1

23. Derivative financial instruments

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Derivatives used for cash flow hedging				
Non-current assets	3.4	1.4	3.4	0.9
Current assets	3.6	4.8	3.1	0.4
Current liabilities	(8.9)	(16.0)	(2.7)	(2.1)
Non-current liabilities	(7.8)	(24.0)	(0.9)	(1.3)
Derivatives used for fair value hedging				
Non-current assets	3.3	2.2	0.8	2.2
Current assets	0.8	0.6	3.3	0.7
Derivatives not in a hedge accounting relationship				
Non-current assets	63.8	70.0	-	-
Current assets	8.5	8.7	-	-
Current liabilities	(0.5)	(1.3)	-	-
Non-current liabilities	(0.4)	(1.2)	-	-

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 (2017 £nil).

During the year a £15.6 million charge (2017 £10.8 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 2018 62% of Group net borrowings were at fixed rate (2017 69%).

At 31 March 2018 the Group had interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £978 million and a weighted average maturity of 2.1 years (2017 £1,078.0 million, with 2.9 years). The weighted average interest rate of the swaps for their nominal amount was 2.0% (2017 2.0%).

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 2018					
Assets	2.8	2.2	1.8	0.2	7.0
Liabilities	(8.9)	(7.8)	-	-	(16.7)
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)
Company					
31 March 2018					
Assets	2.2	2.2	1.9	0.2	6.5
Liabilities	(2.0)	(0.8)	(0.8)	-	(3.6)
31 March 2017					
Assets	0.4	0.4	0.4	0.1	1.3
Liabilities	(2.1)	(1.3)	-	-	(3.4)

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 £3.0 million (2017 £4.9 million).

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23. Derivative financial instruments continued

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	
	2018 £m	2017 £m	2018 £m	2017 £m
Assets				
Derivatives used for cash flow hedging	7.1	6.2	6.5	1.3
Derivatives used for fair value hedging	4.0	2.8	4.1	2.9
Derivatives not in a hedge accounting relationship	72.3	78.7	-	-
Total assets	83.4	87.7	10.6	4.2
Liabilities				
Derivatives used for cash flow hedging	16.7	40.0	3.5	3.4
Derivatives not in a hedge accounting relationship	0.9	2.5	-	-
Total liabilities	17.6	42.5	3.5	3.4

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.

The following table presents the changes in level 3 financial instruments for the year:

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Level 3 inputs				
At 1 April	-	(4.2)	-	(4.2)
Gains recognised in net finance costs	-	6.8	-	6.8
Unwind loss on financial instrument (note 6)	-	(44.8)	-	(83.5)
Amounts to be settled post unwind of financial instrument (notes 6 and 29)	-	44.3	-	44.3
Amounts settled during the year	-	(2.1)	-	36.6
At 31 March	-	-	-	-

24. Financial instruments at fair value through profit

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Current liabilities	(2.6)	(2.4)	(0.4)	-
Non-current liabilities	(46.6)	(48.4)	(1.7)	(1.4)

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.

25. Cash and cash deposits

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Cash at bank and in hand	114.9	101.2	15.2	99.4
Short-term bank deposits	113.0	78.0	113.0	78.0
Other deposits	357.4	418.9	175.1	195.1
Total cash and cash deposits	585.3	598.1	303.3	372.5

Group short-term deposits have an average maturity of 1 day.

Group other deposits have an average maturity of 58 days.

Group other deposits include restricted funds of £182.3 million (2017 £223.8 million) to settle long-term lease liabilities (note 28). 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	
	2018 £m	2017 £m	2018 £m	2017 £m
Cash and cash deposits as above	585.3	598.1	303.3	372.5
Less: deposits with a maturity of three months or more (restricted funds)	(182.3)	(223.8)	-	-
	403.0	374.3	303.3	372.5

26. Trade and other payables – current

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Trade payables	98.2	107.4	0.1	0.2
Amounts owed to subsidiary undertakings	-	-	5.7	0.8
Amounts owed to joint ventures (note 45)	3.7	4.2	-	-
Other tax and social security	48.4	50.6	0.6	0.3
Accruals and other payables	191.7	124.3	50.7	5.0
	342.0	286.5	57.1	6.3

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

At 31 March 2018 Accruals and other payables includes an amount of £44.3 million due to Nomura Structured Holdings plc on unwind of a synthetic derivative (see note 6) which was included in non-current liabilities at 31 March 2017.

27. Current tax liabilities

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Current year creditor	11.8	8.2	(1.7)	-
Prior year tax items	12.6	18.6	25.6	37.9
	24.4	26.8	23.9	37.9

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28. Borrowings

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Current				
Short-term loans	149.6	74.9	149.6	74.9
European Investment Bank	32.0	41.1	-	-
Amounts owed to subsidiary undertakings (note 45)	-	-	283.6	282.9
	181.6	116.0	433.2	357.8
Obligations under finance leases	28.2	30.5	-	-
Total current borrowings	209.8	146.5	433.2	357.8
Non-current				
Bank and other loans	229.0	328.8	149.1	248.6
Private placements	619.6	560.5	562.6	560.5
Bond 2040	133.9	133.6	-	-
RPI index-linked bonds	426.3	416.4	-	-
European Investment Bank	291.4	323.4	-	-
Amounts owed to subsidiary undertakings (note 45)	-	-	-	39.1
	1,700.2	1,762.7	711.7	848.2
Obligations under finance leases	1,476.8	1,353.8	-	-
Total non-current borrowings	3,177.0	3,116.5	711.7	848.2
Total borrowings	3,386.8	3,263.0	1,144.9	1,206.0

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 2017.

The fair values of non-current borrowings, valued using level 2 measures (as set out in note 23) were:

	2018		2017	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Group				
Bank and other loans	229.0	232.8	328.8	336.4
Private placements	619.6	652.3	560.5	614.0
Bond 2040	133.9	197.5	133.6	198.7
RPI index-linked bond	426.3	495.5	416.4	496.2
European Investment Bank	291.4	251.5	323.4	282.3
	1,700.2	1,829.6	1,762.7	1,927.6
Obligations under finance leases	1,476.8	1,350.0	1,353.8	1,217.3
	3,177.0	3,179.6	3,116.5	3,144.9
Company				
Bank and other loans	149.1	152.4	248.6	256.4
Private placements	562.6	595.4	560.5	614.0
Amounts owed to subsidiary undertakings (note 45)	-	-	39.1	39.1
	711.7	747.8	848.2	909.5

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	
	2018 £m	2017 £m	2018 £m	2017 £m
Between 1 and 2 years	190.6	207.7	102.0	188.6
Over 2 year and less than 5 years	574.3	408.3	260.6	148.1
Over 5 years	2,412.1	2,500.5	349.1	511.5
	3,177.0	3,116.5	711.7	848.2

The weighted average maturity of non-current borrowings was 19 years (2017 22 years).

28. Borrowings continued

Finance lease liabilities – minimum lease payments were:

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Within 1 year	52.1	44.3	-	-
Over 1 year and less than 5 years	310.8	245.3	-	-
Over 5 years	2,121.7	2,021.3	-	-
	2,484.6	2,310.9	-	-
Less: future finance charges	(979.6)	(926.6)	-	-
Present value of finance lease liabilities	1,505.0	1,384.3	-	-

The maturity of finance lease liabilities was:

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Within 1 year	28.2	30.5	-	-
Over 1 year and less than 5 years	209.7	175.4	-	-
Over 5 years	1,267.1	1,178.4	-	-
	1,505.0	1,384.3	-	-

Included above are accrued finance charges arising on obligations under finance leases totalling £155.7 million (2017 £146.3 million), of which £3.4 million (2017 £2.0 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, £87.9 million at 31 March 2018 (2017 £79.3 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 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, £92.5 million at 31 March 2018 (2017 £142.4 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	
	2018 £m	2017 £m	2018 £m	2017 £m
Floating rate:				
Expiring within 1 year	180.0	60.0	100.0	60.0
Expiring after 1 year	405.9	725.0	125.0	180.0
	585.9	785.0	225.0	240.0

In addition at 31 March 2018 the Group had undrawn uncommitted short-term bank facilities of £300 million (2017 £150 million) available to the Company.

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29. Other non-current liabilities

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Amounts owed to subsidiary undertakings	-	-	8.7	8.7
Deferred income	118.5	114.5	-	-
Other payables	21.6	66.2	-	44.3
	140.1	180.7	8.7	53.0

Deferred income includes amounts relating to the adoption at fair value of assets transferred from customers in the water segment.

In the prior year, other payables included an amount of £44.3 million due to Nomura Structured Holdings plc on unwind of a synthetic derivative (see note 6) which this year is included within current liabilities.

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 £6.1 million (2017 £5.3 million).

Defined benefit schemes

Assumptions

The principal actuarial assumptions at 31 March were:

	2018 %	2017 %	2016 %
Rate of increase in pensionable pay	3.2	3.2	2.9
Rate of increase for current and future pensions	3.0	2.0	2.9
Rate used to discount schemes' liabilities and expected return on schemes' assets	2.70	2.55	3.30
Inflation	3.2	3.2	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 2016 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:

	2018	2017	2016
Male	24.9	24.8	25.1
Female	27.3	27.2	27.3

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

	2018	2017	2016
Male	26.3	26.2	26.5
Female	29.6	29.5	29.6

30. Retirement benefit obligations continued

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%	+/- 6.3%
Rate used to discount schemes' liabilities	+/- 0.5%	+/- 9.3%
Inflation	+/- 0.5%	+/- 6.8%
Life expectancy	+/- 1 year	+/- 4.6%

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.

The amounts recognised in the balance sheet were:

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Present value of financial obligations	(931.2)	(956.0)	(56.5)	(58.0)
Fair value of plan assets	898.5	903.4	53.2	53.9
Deficit of funded plans	(32.7)	(52.6)	(3.3)	(4.1)
Impact of minimum funding asset ceiling	(16.8)	(15.4)	-	-
Net liability recognised in the balance sheet	(49.5)	(68.0)	(3.3)	(4.1)

The movement in the net defined benefit obligation over the accounting period is as follows:

	2018			2017		
	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	(971.4)	903.4	(68.0)	(833.6)	792.7	(40.9)
Current service cost	(13.9)	-	(13.9)	(12.0)	-	(12.0)
Past service cost and gains and losses on settlements	(0.7)	-	(0.7)	(1.5)	-	(1.5)
Interest (expense)/income	(24.1)	22.5	(1.6)	(27.4)	26.2	(1.2)
	(38.7)	22.5	(16.2)	(40.9)	26.2	(14.7)
Remeasurements:						
Return/ (loss) on plan on assets excluding amounts included in interest expense	-	(5.7)	(5.7)	-	106.0	106.0
Gain from change in demographic assumptions	1.0	-	1.0	12.2	-	12.2
(Loss)/ gain from change in financial assumptions	30.6	-	30.6	(133.1)	-	(133.1)
Experience losses	(1.4)	-	(1.4)	(8.7)	-	(8.7)
	30.2	(5.7)	24.5	(129.6)	106.0	(23.6)
Contributions:						
Employers	-	10.2	10.2	-	11.2	11.2
Plan participants	(1.0)	1.0	-	(1.1)	1.1	-
Payments from plans:						
Benefit payments	32.9	(32.9)	-	33.8	(33.8)	-
	31.9	(21.7)	10.2	32.7	(21.5)	11.2
At 31 March	(948.0)	898.5	(49.5)	(971.4)	903.4	(68.0)

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30. Retirement benefit obligations continued

The movement in the Company's net defined benefit obligation over the accounting period is as follows:

	2018			2017		
	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	(58.0)	53.9	(4.1)	(50.7)	47.7	(3.0)
Current service cost	(0.3)	-	(0.3)	(0.2)	-	(0.2)
Interest (expense)/income	(1.5)	1.3	(0.2)	(1.8)	1.7	(0.1)
	(1.8)	1.3	(0.5)	(2.0)	1.7	(0.3)
Remeasurements:						
(Loss)/return on plan on assets excluding amounts included in interest expense	-	(0.1)	(0.1)	-	6.0	6.0
Gain from change in demographic assumptions	-	-	-	1.0	-	1.0
Gain/(loss) from change in financial assumptions	1.8	-	1.8	(9.0)	-	(9.0)
Experience gains	(0.6)	-	(0.6)	0.5	-	0.5
	1.2	(0.1)	1.1	(7.5)	6.0	(1.5)
Contributions:						
Employers	-	0.2	0.2	-	0.7	0.7
Payments from plans:						
Benefit payments	2.1	(2.1)	-	2.2	(2.2)	-
	2.1	(1.9)	0.2	2.2	(1.5)	0.7
31 March	(56.5)	53.2	(3.3)	(58.0)	53.9	(4.1)

Changes in the effect of the asset ceiling during the year were:

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Irrecoverable asset at start of the year	15.8	7.6	-	-
Interest on irrecoverable surplus	0.4	0.2	-	-
Actuarial gains	1.1	8.0	-	-

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:

	2018			2017		
	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	208.3	-	23	243.7	1.9	27
Government bonds	170.2	-	19	168.8	-	19
Other bonds	211.9	-	24	170.0	-	19
Diversified growth	182.3	7.9	21	96.8	-	11
Property	57.4	9.9	7	52.1	8.8	7
Insurance linked security	41.8	-	5	47.2	-	5
Other (including cash funds)	8.8	-	1	100.2	13.9	12
	880.7	17.8	100	878.8	24.6	100

30. Retirement benefit obligations continued

Other assets at 31 March 2018 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:

	2018			2017		
	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	10.5	-	20	13.0	-	24
Government bonds	10.7	-	20	10.5	-	19
Other bonds	13.3	-	24	10.1	-	19
Diversified growth	10.4	-	20	6.2	-	12
Property	4.7	-	9	4.2	-	8
Insurance linked security	3.3	-	6	3.8	-	7
Other	0.3	-	1	6.1	-	11
	53.2	-	100	53.9	-	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.£13 million per annum rising with inflation from 2019 to 2022. The Group's deficit recovery contribution to the main scheme for 2018 has been paid in earlier periods (2017 £0.5 million). The Group monitors funding levels on an annual basis and expects to pay total contributions of around £27 million during the year ended 31 March 2019.

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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	
	2018 £m	2017 £m	2018 £m	2017 £m
Liabilities/(assets) at 1 April	269.6	272.0	(2.3)	(2.2)
Charged/(credited) to the income statement	18.3	18.9	(0.2)	-
Charged/(credited) to equity	8.1	(2.3)	0.9	-
Change of rate in income statement – non-underlying	-	(21.3)	-	(0.1)
Other non-underlying charges in the income statement	(0.4)	2.3	-	-
Liabilities/(assets) at 31 March	295.6	269.6	(1.6)	(2.3)

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.

In the prior year the deferred tax balance was 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 included 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	Derivatives £m	Other £m	Total £m
At 1 April 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 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
Charged/(credited) to the income statement	18.1	(1.5)	2.0	-	(0.4)	18.2
Transfer from deferred tax assets	-	-	-	0.7	-	0.7
At 31 March 2018	259.9	20.6	43.7	0.7	-	324.9

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 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 charge/(credit) 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 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)
(Credited)/charged to the income statement	1.0	(1.1)	-	0.4	-	0.1	(0.3)	0.1
Non-underlying (credit)/charge to the income statement	-	-	(0.4)	-	-	-	-	(0.4)
Charged to equity	-	4.2	3.5	0.4	-	-	-	8.1
Transfer to deferred tax liabilities	-	-	(0.7)	-	-	-	-	(0.7)
At 31 March 2018	(5.4)	(8.4)	-	(0.8)	(1.7)	(9.9)	(3.1)	(29.3)
Net liability:								
At 31 March 2017								269.6
At 31 March 2018								295.6

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 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)
(Credited)/ charged to the income statement	(0.1)	-	0.1	(0.2)	(0.2)
Charged to equity	0.2	0.6	0.1	-	0.9
At 31 March 2018	(0.6)	(0.5)	(0.2)	(0.3)	(1.6)

Deferred tax (charged)/credited to equity during the year was:

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Remeasurement of defined benefit obligations	(4.2)	3.3	(0.2)	0.1
Cash flow hedges	(3.5)	(1.3)	(0.6)	(0.2)
Deferred tax on other comprehensive loss/(gain)	(7.7)	2.0	(0.8)	(0.1)
Share-based payments	(0.4)	0.3	(0.1)	0.1
	(8.1)	2.3	(0.9)	-

32. Provisions

	Environmental and landfill restoration £m	Restructuring £m	Other provisions £m	Total £m
Group				
At 1 April 2017	183.8	6.5	23.9	214.2
Charged to the income statement	6.7	-	0.9	7.6
Capitalised	11.1	-	-	11.1
Utilised	(9.7)	(3.1)	(0.6)	(13.4)
At 31 March 2018	191.9	3.4	24.2	219.5

The amount charged to the income statement includes £10.2 million (2017 £9.1 million) charged to finance costs as the unwinding of discounts in provisions.

The analysis of provisions between current and non-current is:

	2018 £m	2017 £m
Current	38.0	40.4
Non-current	181.5	173.8
	219.5	214.2

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 4.825% (2017 4.75%) and an inflation rate of 2.5% (2017 2.5%) to its aftercare provision and a discount rate of 3.8% (2017 4.75%) and an inflation rate of 2.5% (2017 2.5%) to its restoration provision.

The restructuring provision relates principally to severance costs and will be utilised within one year.

Other provisions include underperforming contracts of £11.0 million (2017 £11.1 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 6 years.

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33. Share capital

Allotted, called-up and fully paid

Group and Company	Number of shares		£m
	Treasury shares	Ordinary shares	
At 1 April 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
Shares issued under the Scrip Dividend Alternative	-	5,223,293	2.1
For consideration of £0.5 million, shares issued to the Pennon Employee Share Trust	-	46,205	0.1
For consideration of £3.4 million, shares issued under the Company's Sharesave Scheme	-	580,392	0.2
At 31 March 2018 ordinary shares of 40.7p each	8,443	419,743,183	170.8

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 or fifth 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	
			2018	2017
28 June 2010	431p	2013 - 2017	-	41
29 June 2011	536p	2014 - 2017	26	29
29 June 2012	588p	2015 - 2017	2	91
3 July 2013	538p	2016 - 2017	94	103
14 July 2014	611p	2017 - 2018	159	609
24 June 2015	683p	2017 - 2020	933	1,132
29 June 2016	709p	2019 - 2021	605	748
28 June 2017	767p	2020 - 2022	671	-
			2,490	2,753

33. Share capital continued

The number and weighted average exercise price of Sharesave options are:

	2018		2017	
	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	2,753	660	2,856	619
Granted	775	767	798	709
Forfeited	(411)	707	(205)	661
Exercised	(570)	597	(610)	533
Expired	(57)	667	(86)	639
At 31 March	2,490	700	2,753	660

The weighted average price of the Company's shares at the date of exercise of Sharesave options during the year was 798p (2017 878p). The options outstanding at 31 March 2018 had a weighted average exercise price of 700p (2017 660p) and a weighted average remaining contractual life of 1.6 years (2017 1.9 years).

The aggregate fair value of Sharesave options granted during the year was £0.9 million (2017 £0.9 million), determined using the Black-Scholes valuation model. The significant inputs into the valuation model at the date of issue of the options were:

	2018	2017
Weighted average share price	848	854
Weighted average exercise price	767	709
Expected volatility	19.0%	18.0%
Expected life	3.4 years	3.4 years
Risk-free rate	0.3%	0.3%
Expected dividend yield	4.5%	4.2%

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. From 2017/18, no further awards are made under this Plan as it has been superseded by a Long-term Incentive Plan (see iii) below).

The number and price of shares in the Performance and Co-investment Plan are:

	2018		2017	
	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	1,021	850	1,198	761
Granted	-	-	378	920
Vested	(50)	799	(128)	653
Lapsed	(400)	852	(427)	721
At 31 March	571	865	1,021	850

The awards outstanding at 31 March 2018 had a weighted exercise price of 865p (2017 850p) and a weighted average remaining contractual life of 0.7 years (2017 1.3 years).

The aggregate fair value of awards granted in the prior year was £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
Weighted average share price	920p
Expected volatility	18.0%
Risk-free rate	0.3%

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

Notes to the financial statements

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33. Share capital continued

iii) Long-term Incentive Plan (LTIP)

Executive Directors and senior management receive an annual grant of conditional shares. Share awards vest subject to the achievement of specific performance conditions measured over a performance period of not less than three years.

The number and price of shares in the LTIP are:

	2018	
	Number of ordinary shares (thousands)	Weighted average exercise price per share (p)
At 1 April	-	-
Granted	537	803
Lapsed	(27)	803
At 31 March	510	803

The awards outstanding at 31 March 2018 had a weighted exercise price of 803p and a weighted average remaining contractual life of 2.4 years.

The aggregate fair value of awards granted during the year was £1.0 million, determined from market value. No option pricing methodology is applied is applied since the vesting of the shares depend on non-market performance vesting conditions.

iv) 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:

	2018		2017	
	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	325	848	307	759
Granted	172	809	146	944
Vested	(51)	821	(122)	745
Lapsed	(41)	815	(6)	701
At 31 March	405	843	325	848

The awards outstanding at 31 March 2018 had a weighted average exercise price of 843p (2017 848p) and a weighted average remaining contractual life of 1.5 years (2017 1.4 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 £0.9 million (2017 £1.3 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 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
Adjustment for shares issued under the Scrip Dividend Alternative	(2.1)
Shares issued under the Sharesave Scheme	3.1
Shares issued to the Pennon Employee Share Trust	0.4
At 31 March 2018	218.8

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 2016	144.2
At 31 March 2017	144.2
At 31 March 2018	144.2

36. Retained earnings and other reserves

	Own shares £m	Hedging reserve £m	Retained earnings £m	Total £m
Group				
At 1 April 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
Profit for the year	-	-	200.6	200.6
Other comprehensive income for the year	-	17.1	17.5	34.6
Redemption of perpetual capital securities (see note 37)	-	-	(5.2)	(5.2)
Dividends paid relating to 2017	-	-	(149.5)	(149.5)
Adjustment for shares issued under the Scrip Dividend Alternative	-	-	41.7	41.7
Credit to equity in respect of share-based payments (net of tax)	-	-	2.2	2.2
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	(1.7)	-	-	(1.7)
At 31 March 2018	(3.5)	(11.1)	821.7	807.1

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 440,000 ordinary shares (2017 330,000 ordinary shares) held by the Trust at 31 March 2018 was £2.8 million (2017 £2.9 million).

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continued

36. Retained earnings and other reserves continued

	Hedging reserve £m	Retained earnings £m	Total £m
Company			
At 1 April 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
Profit for the year	–	215.1	215.1
Other comprehensive loss for the year	2.7	0.9	3.6
Dividends paid relating to 2017	–	(149.5)	(149.5)
Adjustment for shares issued under the Scrip Dividend Alternative	–	41.7	41.7
Redemption of perpetual capital securities (see note 37)	–	(5.2)	(5.2)
Credit to equity in respect of share-based payments (net of tax)	–	0.8	0.8
Charge in respect of share options vesting	–	(0.8)	(0.8)
At 31 March 2018	(2.0)	1,113.1	1,111.1

In making decisions about the level of dividends to be proposed the Directors take steps to check that retained earnings reflect realised profits and are therefore distributable within the requirements of the Companies Act 2006.

37. Perpetual capital securities

	£m
Group and Company	
At 1 April 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
Issuance of perpetual capital securities	296.7
Redemption of perpetual capital securities	(294.8)
Distributions to perpetual capital security holders	(25.3)
Current tax relief on distributions to perpetual capital security holders	3.8
Profit for the year attributable to perpetual capital security holders	21.5
At 31 March 2018	296.7

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 had no fixed redemption date but the Company could 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. In the event the Company acquired 80% or more of the securities it could then redeem the remainder at its sole discretion.

On 22 September 2017 the Company purchased £285.8 million in principal amount of the capital securities and settled accrued periodic returns totalling £19.0 million for a total of £304.8 million. On 10 October 2017 the Company exercised its option to redeem all of the remaining £14.2 million capital securities at their principal amount and accrued periodic returns totalling £0.6 million.

On 22 September 2017 the Company issued £300 million perpetual capital securities. Costs directly associated with the issue of £3.3 million were set off against the value of the issuance. They have no fixed redemption date but the Company can at its sole discretion redeem all, but not part, of these securities at their principal amount on 22 May 2020 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 22 May 2018, a periodic return of £5.8 million has been recognised as a financial liability at the year end.

Profits for the year attributable to perpetual capital security holders of £21.5 million reflect £19.6 million of distributions noted above on the March 2013 perpetual capital securities, £3.8 million of associated corporation tax relief and £5.8 million for periodic returns due on 2017 perpetual capital securities. (The newly issued securities do not qualify for corporation tax relief).

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	
	2018 £m	2017 £m	2018 £m	2017 £m
Continuing operations				
Profit for the year	221.9	180.5	236.6	179.1
Adjustments for:				
Share-based payments	2.5	2.9	0.9	1.1
Profit on disposal of property, plant and equipment	(2.5)	(7.5)	-	-
Depreciation charge	182.5	178.2	0.1	0.1
Amortisation of intangible assets	3.6	3.2	-	-
Non-underlying provision charge	-	10.7	-	-
Non-underlying JV loan write off and credit	(6.5)	-	-	-
Non-underlying remeasurement of fair value movement in derivatives	2.4	(16.0)	-	-
Non-underlying unwind of synthetic derivative	-	44.8	-	83.5
Share of post-tax profit from joint ventures	(9.4)	(4.2)	-	-
Finance income (before non-underlying items)	(24.2)	(36.3)	(42.5)	(51.1)
Finance costs (before non-underlying items)	98.7	95.1	34.6	37.1
Dividends receivable	-	-	(202.3)	(247.0)
Taxation charge/(credit)	41.0	30.0	(28.4)	(3.3)
Changes in working capital:				
Increase in inventories	(5.2)	(0.7)	-	-
(Increase)/decrease in trade and other receivables	(36.9)	(13.1)	250.6	(158.1)
Increase in service concession arrangements receivable	(15.2)	(22.2)	-	-
Increase in trade and other payables	2.2	8.5	0.1	0.1
Increase/(decrease) in retirement benefit obligations from contributions	4.5	2.3	(0.3)	(0.5)
Decrease in provisions	(15.9)	(24.7)	-	-
Cash generated/(outflow) from operations	443.5	431.5	249.4	(159.0)

Reconciliation of total interest paid:

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Interest paid in operating activities	69.6	76.4	32.5	39.1
Interest paid in investing activities	17.0	12.9	-	-
Total interest paid	86.6	89.3	32.5	39.1

Notes to the financial statements

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39. Net borrowings

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Cash and cash deposits	585.3	598.1	303.3	372.5
Borrowings – current				
Bank and other loans	(149.6)	(74.9)	(149.6)	(74.9)
Other current borrowings	(32.0)	(41.1)	-	-
Finance lease obligations	(28.2)	(30.5)	-	-
Amounts owed to subsidiary undertakings	-	-	(283.6)	(282.9)
Total current borrowings	(209.8)	(146.5)	(433.2)	(357.8)
Borrowings – non-current				
Bank and other loans	(1,408.8)	(1,439.3)	(711.7)	(848.2)
Other non-current borrowings	(291.4)	(323.4)	-	-
Finance lease obligations	(1,476.8)	(1,353.8)	-	-
Total non-current borrowings	(3,177.0)	(3,116.5)	(711.7)	(848.2)
Total net borrowings	(2,801.5)	(2,664.9)	(841.6)	(833.5)

The movements in net borrowings during the periods presented were as follows:

Group	Net borrowings at 1 April 2016 £m	Cash flows – other £m	Foreign exchanged adjustments £m	Other non-cash movements £m	Net borrowings at 31 March 2017 £m
Cash and cash deposits	632.2	(34.1)	-	-	598.1
Bank and other loans due within one year	-	-	-	(74.9)	(74.9)
Other current borrowings	(39.0)	39.0	-	(41.1)	(41.1)
Finance leases due within one year	(26.0)	26.0	-	(30.5)	(30.5)
Bank and other loans due after one year	(1,502.5)	(0.5)	(2.3)	66.0	(1,439.3)
Other non-current borrowings	(234.5)	(130.0)	-	41.1	(323.4)
Finance leases due after one year	(1,314.6)	(12.1)	-	(27.1)	(1,353.8)
	(2,484.4)	(111.7)	(2.3)	(66.5)	(2,664.9)

	Net borrowings at 1 April 2017 £m	Cash flows – other £m	Foreign exchanged adjustments £m	Other non-cash movements £m	Net borrowings at 31 March 2018 £m
Cash and cash deposits	598.1	(12.8)	-	-	585.3
Bank and other loans due within one year	(74.9)	74.9	-	(149.6)	(149.6)
Other current borrowings	(41.1)	41.1	-	(32.0)	(32.0)
Finance leases due within one year	(30.5)	30.5	-	(28.2)	(28.2)
Bank and other loans due after one year	(1,439.3)	(106.9)	(2.3)	139.7	(1,408.8)
Other non-current borrowings	(323.4)	-	-	32.0	(291.4)
Finance leases due after one year	(1,353.8)	(117.1)	-	(5.9)	(1,476.8)
	(2,664.9)	(90.3)	(2.3)	(44.0)	(2,801.5)

Company	Net borrowings at 1 April 2017 £m	Cash flows – other £m	Foreign exchanged adjustments £m	Other non-cash movements £m	Net borrowings at 31 March 2018 £m
Cash and cash deposits	429.7	(57.2)	-	-	372.5
Bank and other loans due within one year	-	-	-	(74.9)	(74.9)
Amounts due to subsidiary undertakings	(287.2)	-	-	4.3	(282.9)
Bank and other loans due after one year	(877.1)	-	-	28.9	(848.2)
	(734.6)	(57.2)	-	(41.7)	(833.5)

	Net borrowings at 1 April 2017 £m	Cash flows – other £m	Foreign exchanged adjustments £m	Other non-cash movements £m	Net borrowings at 31 March 2018 £m
Cash and cash deposits	372.5	(69.2)	-	-	303.3
Bank and other loans due within one year	(74.9)	25.0	-	(99.7)	(149.6)
Amounts due to subsidiary undertakings	(282.9)	(0.7)	-	-	(283.6)
Bank and other loans due after one year	(848.2)	-	-	136.5	(711.7)
	(833.5)	(44.9)	-	36.8	(841.6)

The increase in the value of Financial liabilities at fair value through profit in the year of £0.4m for the Group and £0.7m for the Company is attributable to Other non-cash movements.

40. Subsidiary, joint venture and associate undertakings at 31 March 2018

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
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
Non-household retail		
Pennon Water Services Limited ⁽¹⁾	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Other		
Peninsula Insurance Limited ⁽²⁾	Level 5, Mill Court, La Charroterie, St Peter Port, GY1 1EJ	Guernsey

(1) 80% of share capital owned by Pennon Group plc. All shares in issue are ordinary shares.

(2) Captive insurance company established with the specific objective of financing risks emanating from within the Group.

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40. Subsidiary, joint venture and associate undertakings at 31 March 2018 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
Cambridge Water Business 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
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* (in liquidation)	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Peninsula Water Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England

40. Subsidiary, joint venture and associate undertakings at 31 March 2018 continued

Other dormant companies	Registered office address	Country of incorporation
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
South Staffordshire Water Business 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 7HT	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
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.

Notes to the financial statements

continued

40. Subsidiary, joint venture and associate undertakings at 31 March 2018 continued

Joint ventures and associate

All joint ventures, the associate and the subsidiary undertakings of Lakeside Energy from Waste Holdings Limited, INEOS Runcorn (TPS) Holdings Limited and Shelford Composting Limited are incorporated and registered in England which is also their country of operation. The registered office of Lakeside Energy from Waste Holdings Limited and Lakeside Energy from Waste Limited is Thames House, Oxford Road, Wallingford OX10 6LX. The registered office of Shelford Composting Limited is 900 Pavilion Drive, Northampton NN4 7RG.

	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			
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 186,750 B1 ordinary shares 62,250 B2 ordinary shares	20% 50% -	
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	
	2018 £m	2017 £m	2018 £m	2017 £m
The future aggregate minimum lease payments under non-cancellable operating leases are:				
Within 1 year	10.8	10.6	-	-
Over 1 year and less than 5 years	29.1	28.2	-	-
Over 5 years	123.0	104.5	-	-
	162.9	143.3	-	-

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 33 years and rentals are reviewed on average at five-yearly intervals.

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

42. Contingencies

Contingent liabilities

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Guarantees:				
Borrowing facilities of subsidiary undertakings	-	-	549.6	555.9
Performance bonds	185.1	187.5	185.1	187.5
	185.1	187.5	734.7	743.4

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

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 2018 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 include a potential prosecution by the Health and Safety Executive.

42. Contingencies continued

Contingent assets

In addition to contractual receivables related to our construction contracts in respect of Glasgow Recycling and Renewable Energy Centre that are reflected in the financial statements, there are further possible recoveries that are contingent on events in the future that are not wholly within the Group's control. These contingent assets have not been recognised as at 31 March 2018.

43. Capital commitments

	Group		Company	
	2018 £m	2017 £m	2018 £m	2017 £m
Contracted but not provided	287.7	401.1	-	-

44. Acquisition

On 1 April 2017 Pennon Water Services Limited, a wholly owned subsidiary of Pennon Group plc (Pennon) at the start of the year, acquired 100% of the issued share capital of SSWB Limited, including its two dormant subsidiary companies, South Staffordshire Water Business (SSWB) Limited and Cambridge Water Business Limited, for a total consideration of £8.4 million.

The acquisition was part of the formation of a non-household retail venture with South Staffordshire plc (SS), incorporating South Staffs and Cambridge Water, to participate in the non-household retail market which commenced 1 April 2017.

On the same date Pennon Water Services also purchased assets, primarily trade receivables from South West Water Limited, a fellow subsidiary of Pennon, for a total consideration of £336 million.

The acquisition of SSWB Limited has been accounted for using the acquisition method. No goodwill has arisen as the book value of the net assets of SSWB Limited at the point of acquisition equated to their fair value.

The consideration was financed by the issuance to SS of new equity share capital in Pennon Water Services of £1.7 million and the issuance of a loan from SS to Pennon Water Services of £6.7 million. Initial placements of equity and debt were made on 1 April 2017 for £0.7 million and £6.3 million respectively with final placements of £1.0 million and £0.4 million on 29 March 2018 upon final agreement of asset values within SSWB Limited.

As a result of these transactions Pennon now holds a majority 80% equity share in Pennon Water Services, with SS holding the remaining 20% non-controlling interest.

Directly attributable costs included in other operating expenses were £0.4 million.

	£m	£m
Fair values on acquisition of SSWB Limited		
Intangible assets		0.5
Trade and other receivables		7.9
Total consideration		8.4
Satisfied by cash payment, which was financed by:		
Issuance of equity share capital in Pennon Water Services	1.7	
Issuance of loan from SS to Pennon Water Services	6.7	
		8.4

The fair value of trade and other receivables in SSWB Limited on acquisition was £7.9 million. This included gross contracted amounts receivable of £10.9 million, of which £3.0 million were not expected to be collected.

Revenue and costs associated with the assets acquired are all included in the Consolidated Income Statement for the full year ended 31 March 2018.

45. 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:

	2018 £m	2017 £m
Sales of goods and services		
Viridor Laing (Greater Manchester) Limited	38.4	80.1
INEOS Runcorn (TPS) Limited	15.9	15.8
Purchase of goods and services		
Lakeside Energy from Waste Limited	12.0	10.4
INEOS Runcorn (TPS) Limited	6.0	6.6
Dividends received		
Lakeside Energy from Waste Holdings Limited	6.5	4.5

Notes to the financial statements

continued

45. Related party transactions continued

Year-end balances

	2018 £m	2017 £m
Receivables due from related parties		
Viridor Laing (Greater Manchester) Limited (loan balance)	-	40.2
Lakeside Energy from Waste Limited (loan balance)	8.2	8.6
INEOS Runcorn (TPS) Limited (loan balance)	32.5	37.8
	40.7	86.6
Viridor Laing (Greater Manchester) Limited (trading balance)	-	15.3
Lakeside Energy from Waste Limited (trading balance)	1.0	1.0
INEOS Runcorn (TPS) Limited (trading balance)	2.0	1.3
	3.0	17.6
Payables due to related parties		
Lakeside Energy for Waste Limited (trading balance)	1.2	2.7
INEOS Runcorn (TPS) Limited (trading balance)	2.5	1.5
	3.7	4.2

The £40.8 million (2017 £86.6 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% (2017 13.0%).

Company

The following transactions with subsidiary undertakings occurred in the year:

	2018 £m	2017 £m
Sales of goods and services (management fees)	12.2	11.2
Purchase of goods and services (support services)	1.5	0.5
Interest receivable	39.9	39.6
Interest payable	0.1	0.1
Dividends received	202.3	247.0

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

Year-end balances

	2018 £m	2017 £m
Receivables due from subsidiary undertakings		
Loans	870.8	1,124.3
Trading balances	16.2	13.4

Interest on £425.3 million of the loans has been charged at a fixed rate of 5.0% and on £20.3 million at a fixed rate of 6.0% (2017 £70.0 million at 4.5%, £428.0 million nil at 5.0% and £28.0 million at 6.0%). Interest on £411.8 million of the loans is charged at 12 month LIBOR +1.0% (2017 £497.8 million) and on £13.4 million at 12 month LIBOR +3.0% (2017 nil). These loans are due for repayment in instalments over the period 2018 to 2056.

Loans of £100.0 million at 1 month LIBOR + 1.0% and £0.5 million at base rate +1.0% were repaid during the year.

During the year there were no provisions (2017 nil) in respect of loans to subsidiaries not expected to be repaid.

	2018 £m	2017 £m
Payables due to subsidiary undertakings		
Loans	283.6	322.0
Trading balances	14.4	9.5

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

Five-year financial summary

	2018 £m	2017 £m	2016 £m	2015 £m	2014 £m
Income statement					
Revenue before non-underlying items	1,393.0	1,353.1	1,352.3	1,357.2	1,321.2
Operating profit before non-underlying items	323.9	304.6	261.8	246.6	257.5
Net finance costs before non-underlying items	(74.5)	(58.8)	(54.1)	(40.8)	(53.9)
Share of profit in joint ventures	9.4	4.2	3.6	4.9	3.7
Profit before tax and non-underlying items	258.8	250.0	211.3	210.7	207.3
Net non-underlying items before tax	4.1	(39.5)	(5.0)	(13.7)	(48.6)
Taxation charge	(41.0)	(30.0)	(38.0)	(54.7)	(0.6)
Profit for the year	221.9	180.5	168.3	142.3	158.1
Attributable to:					
Ordinary shareholders of the parent	200.6	164.3	152.1	126.3	142.5
Perpetual capital security holders	21.5	16.2	16.2	16.0	15.6
Non-controlling interests	(0.2)	-	-	-	-
Dividends proposed/declared	162.0	149.5	138.5	129.5	117.0
Earnings per ordinary share (basic):					
From continuing operations					
Earnings per share	48.0p	39.8p	37.0p	32.3p	38.8p
Deferred tax before non-underlying items	4.4p	4.5p	9.5p	4.7p	(7.0)p
Non-underlying items (net of tax)	(1.8)p	2.7p	(7.0)p	2.8p	10.8p
Proportional adjustment on Perpetual capital returns	0.3p	-	-	-	-
Earnings per share before non-underlying and deferred tax	50.9p	47.0p	39.5p	39.8p	42.6p
Declared dividends per share	38.59p	35.96p	33.58p	31.80p	30.31p
Capital expenditure					
Acquisitions	8.4	-	91.0	-	-
Property, plant and equipment	389.0	377.5	284.2	301.4	360.8
Balance sheet					
Non-current assets	5,125.0	4,937.0	4,676.7	4,325.9	4,076.6
Net current assets	412.6	454.4	549.1	586.0	241.9
Non-current liabilities	(3,898.5)	(3,882.2)	(3,738.2)	(3,557.8)	(3,120.9)
Net assets	1,639.1	1,509.2	1,487.6	1,354.1	1,197.6
Number of employees (average for year)					
Water	1,575	1,589	1,706	1,408	1,356
Waste management	3,285	3,153	3,230	3,101	3,044
Non-household retail	81	-	-	-	-
Other businesses	73	57	51	49	51
	5,014	4,799	4,987	4,558	4,451

Shareholder information

Financial calendar

Financial year end	31 March
29th Annual General Meeting	5 July 2018
Ex-dividend date for 2018 final dividend	5 July 2018*
Record date for 2018 final dividend	6 July 2018*
2018 final dividend payable	4 September 2018*
2018/19 half-yearly results announcement	27 November 2018
2019 interim dividend payable	April 2019
2018/19 final results announcement	21 May 2019
30th Annual General Meeting	4 July 2019
2019 final dividend payable	September 2019

Dividend Reinvestment Plan (DRIP) alternative*

Ordinary shares quoted ex-dividend	5 July 2018
Record date for final dividend	6 July 2018
Final date for receipt of DRIP applications	13 August 2018
Posting of dividend cheques	3 September 2018
Final dividend payment date	4 September 2018

* Subject to obtaining shareholder approval at the 2018 Annual General Meeting to the payment of a final dividend for the year ended 31 March 2018.

Shareholder analysis at 31 March 2018

Holding of shares	Number of shareholders	% of total shareholders	% of ordinary shares
1-100	2,429	12.41	0.03
101-1,000	8,235	42.09	1.03
1,001-5,000	7,404	37.84	3.89
5,001-50,000	1,129	5.77	3.11
50,001-100,000	84	0.45	1.42
100,001+	283	1.44	90.51
	19,564		

	Number of accounts	% of total accounts	% of total shares
Individuals	17,151	87.66	6.42
Companies	128	0.66	0.31
Trust companies (pension funds etc.)	8	0.04	0.01
Banks and nominees	2,277	11.64	93.25
	19,564		

Major shareholdings

The net position on 31 March 2018 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	41,575,771	99.1%
Pictet Asset Management SA	25,599,217	6.10%
BlackRock, Inc.	21,700,561	5.17%
Ameriprise Financial, Inc.	20,328,154	4.84%
The Capital Group Companies, Inc.	20,106,888	4.79%
RARE Infrastructure Limited	19,366,782	4.61%
AXA Investment Managers SA	18,088,394	4.31%
Invesco Limited	17,212,959	4.10%
UBS Investment Bank	16,610,004	3.96%

No changes to interests in the Company's issued share capital have been disclosed to the Company between 31 March 2018 and 23 May 2018 (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, Link Asset Services, who can be contacted as follows:

Link 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@linkgroup.co.uk**

Website: **signalshares.com**

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, Link 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).

Dividend Reinvestment Plan (DRIP)

Subject to obtaining shareholder approval at the 2018 Annual General Meeting for the payment of a final dividend for the year ended 31 March 2018, full details of the DRIP and how to participate will be published on the Company's website at **www.pennon-group.co.uk/dividends/dividend-reinvestment-plan-drip**. The full timetable for offering the DRIP is given on page 170.

The DRIP 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 at preferable dealing rates.

Online portfolio service

The online portfolio service provided by Link Asset Services gives shareholders access to more information on their investments. Details of the portfolio service are available online at **www.signalshares.com**.

Electronic communications

The Company has passed a resolution which allows it to communicate with its shareholders by means of its website.

Shareholders currently receiving a printed copy of the annual report who now wish to sign up to receive all future shareholder communications electronically can do so by registering with Link 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.

Shareholder information

continued

Beware of share fraud

The following is taken from the ScamSmart section of the Financial Conduct Authority's website (www.fca.org.uk/scamsmart).

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

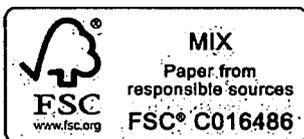
1. Keep in mind that firms authorised by the Financial Conduct Authority (FCA) are unlikely to contact you out of the blue with an offer to buy or sell shares.
2. Do not get into a conversation; note the name of the person and firm contacting you and then end the call.
3. Check the Financial Services 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.fca.org.uk/scamsmart. 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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