

SOUTH WEST WATER LIMITED

ANNUAL REPORT AND FINANCIAL STATEMENTS 2006



This report is published in accordance with the requirements of the
Water Services Regulation Authority

REGISTERED OFFICE: Peninsula House, Rydon Lane, Exeter EX2 7HR
REGISTERED IN ENGLAND NO 2366665

ANNUAL REPORT AND FINANCIAL STATEMENTS 2006

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CHIEF EXECUTIVE'S REVIEW

South West Water continued to deliver excellent financial performance, first class levels of product and ongoing improvements in customer service, whilst outperforming regulatory targets.

South West Water's operating profit rose 11.4% to £140.2m before exceptional costs of £14.5m from a one-off customer payment (2005 exceptional restructuring costs £3.4m). The Company is on track to achieve the operating cost efficiency targets set by the Water Services Regulation Authority for the period to 2010.

Further analysis of the financial results achieved in the year is presented within the Business Review on page 7.

A restructuring and continuous improvement programme designed to reduce overhead and operating costs significantly is a long-term ongoing initiative for South West Water. Its successful delivery is ensuring that the Company continues to outperform the demanding operational and capital efficiency targets imposed by industry regulator Ofwat and it is on track to do so for the remainder of the current regulatory period (K4, 2005 – 2010). Over the past 11 years, base cost efficiency savings totalling £54.2m have been achieved.

Independent market research carried out among South West Water's customers confirms high levels of satisfaction with the overall service provided by the Company, although levels of charges remain an issue for certain clearly defined groups of customers. Plentiful supplies of high quality drinking water are an absolute priority for customers and, as a direct consequence of careful planning and capital expenditure, the region's water storage, treatment and distribution infrastructure has been progressively and significantly enhanced over the years.

There have been no water restrictions in the region since 1996 and the Company's innovative and industry leading leakage detection and reduction programme continues to deliver results in line with mandatory leakage targets set by Ofwat. During the year, two key reservoirs were replenished by pumping water from downstream river flows to supplement the natural raw water inflow. The pumping infrastructure was installed several years ago to provide enhanced drought protection. This has contributed to reservoir levels being marginally higher than at the same time last year.

Over 695 kilometres of water mains were laid, replaced or refurbished during the year and the Company's 'Putting the Sparkle Back Into Your Water' water mains renovation programme has seen record levels of expenditure and refurbished water mains being achieved. Continued high levels of investment in the water mains renovation programme will be a key element during the remainder of the K4 period.

Improvements in water supply have been matched with improvements to water quality and during the year, the Company maintained its highest ever drinking water compliance level of 99.96% with the quality standards set by the Drinking Water Inspectorate.

The Company's massive 'Clean Sweep' coastal sewage treatment improvement programme is now virtually complete apart from a small number of minor schemes which are being delayed because of planning and other related issues. 'Clean Sweep' has transformed the coastal environment of the South West and 89% of the region's bathing waters now meet the stringent EU guideline standards and 99% conform to EU mandatory standards. These quality achievements are amongst the very best in the UK and a testament to all those involved in the delivery of one of the largest environmental improvement programmes of its kind in the whole of Europe.

Inland waste water treatment works are also being updated and modernised as part of a rolling programme to ensure compliance with demanding environmental standards. The successful delivery of both coastal and river water quality improvement programmes has been a pivotal factor in the region's attainment of higher levels of environmental enhancement in support of economic prosperity.

CHIEF EXECUTIVE'S REVIEW (Continued)

Improvements within Ofwat's 'Overall Performance Assessment' have been sustained as capital expenditure, previously constrained whilst the 'Clean Sweep' programme was delivered, is now being directed to address other areas.

Improvements in waste water treatment works compliance continue, but these have been marginally offset by the increased number of sewer flooding incidents caused by factors other than hydraulic overload, such as blockages.

This will be my final contribution to the Annual Report and Financial Statements as I will be retiring at the end of July this year. I am immensely proud of what South West Water has achieved since privatisation in 1989 and I feel very privileged to have been at the helm during a period of tremendous challenge and change. I consider myself fortunate to have led such a good team and I would like to take this opportunity of thanking them and all those associated with the Company who have enabled me to look back with pride on the progress made.

A handwritten signature in cursive script, appearing to read 'R J Baty', written in black ink.

R J Baty OBE
Chief Executive

DIRECTORS, REGISTERED OFFICE AND AUDITORS

| | |
|-------------------------------|---|
| Chairman | K G Harvey |
| Chief Executive | R J Baty |
| Operations Director | S C Bird |
| Finance & Regulatory Director | R M P Hughes |
| Customer Service Director | M S Read |
| Secretary | K D Woodier |
| Registered Office | Peninsula House Rydon Lane Exeter EX2 7HR |
| Auditors | PricewaterhouseCoopers LLP Chartered Accountants 31 Great George Street Bristol BS1 5QD |

NOTICE OF MEETING

The seventeenth Annual General Meeting of South West Water Limited will be held at Peninsula House, Rydon Lane, Exeter on 18 July 2006 at 10.00 am for the transaction of the following business:-

- Resolution 1 To receive the Report of the Directors and the audited financial statements for the year ended 31 March 2006.
- Resolution 2 To re-appoint PricewaterhouseCoopers LLP as auditors of the Company to hold office until the conclusion of the next general meeting at which accounts are laid before the Company and to authorise the Directors to fix their remuneration.

By Order of the Board

K D Woodier
Secretary
Peninsula House
Rydon Lane
Exeter EX2 7HR

6 July 2006

For the purposes of the appointment of auditors (Resolution 2 in this notice), Special notice in accordance with Sections 379 and 388(3), Companies Act 1985 of the intention to move Resolution 2 as an ordinary resolution has been received by the Company.

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

REPORT OF THE DIRECTORS

The Directors submit their annual report and the audited financial statements for the year ended 31 March 2006.

PRINCIPAL ACTIVITIES

The principal activities of the Company are the provision of water and sewerage services. The Company holds the water and sewerage appointments for Cornwall and Devon and small areas of Somerset and Dorset.

BUSINESS REVIEW

Financial Results

Changes in accounting policies implemented in the year are set out in note 1 to the financial statements on page 18. The most significant change was the adoption of FRS 17 "Retirement Benefits" which resulted in an increase in profit before tax of £1.5m (2005 £3.1m) and a pension fund deficit (net of deferred tax) of £24.1m (2005 £46.7m) being reported on the balance sheet at the end of the year. Further details are given in note 22 to the financial statements on page 40.

South West Water turnover rose by £41.5m to £351.5m. Approved tariff increases amounted to £49.5m. Customers switching from unmeasured to metered charging caused a reduction of £7.9m in turnover. Each customer switching to a meter saved an average £250 on their annual bill. Other factors balanced out, with 7,400 new customer connections offset by an estimated £3.5m reduction in metered demand.

Operating profit rose 11.4% to £140.2m, before the exceptional cost of a one-off customer payment of £14.5m (2005 exceptional restructuring costs of £3.4m). Operating efficiencies of £4.0m made a strong contribution to offsetting other additional costs, mainly arising from increased depreciation and operating costs from new and improved works (£6.2m), infrastructure renewals charge (£6.3m), inflation (£8.4m) and the direct charging of leakage and UV costs to operating costs rather than through the infrastructure renewals charge (£6.0m). The Company has implemented further restructuring to contribute towards the additional efficiencies required over the K4 period (2005 – 2010), including a £13m per annum reduction in base operating costs by 2010.

Net interest cost before exceptional costs rose by £2.8m (5.4%) to £54.2m, reflecting higher borrowings due to capital expenditure in the year, the increase in gearing arising from financial restructuring undertaken towards the end of the year and the cost of the exceptional charges associated with that restructuring offset by lower interest rates on the replacement of maturing borrowing (see paragraph on Financing below).

The Company's taxation position results in a credit to mainstream corporation tax of £10.2m (2005 charge of £2.1m) for the year. This position mainly reflects a credit of £7.8m resulting from a re-assessment of the corporation tax due for prior periods following submission of detailed computations and the surrender of £4.0m of taxable losses to other Pennon Group companies. The Company continues to benefit from substantial capital allowances generated by the capital expenditure programme, but changes to the tax regime have resulted in lower allowances than previously and the tax impact of capital allowances being in excess of depreciation being reduced (£3.8m for 2005/06, down from £16.0m in 2004/05). A discounted provision for deferred tax has been made resulting in a charge of £6.7m in the year (2005 £10.0m).

Investment

Capital expenditure increased by 39.3% to £197.6m. £113.1m was invested in water supply improvements including water mains renovation and water treatment works enhancement, principally for nitrate and pesticide removal. Ofwat's latest report on leakage notes that South West Water continues to be one of the leading companies in managing water leakage and is delivering results in line with Ofwat's leakage target. Drinking water quality performance was the best ever at 99.96% compliance, supported by the laying, replacement or refurbishment of 695 km of water mains, a major increase on 2004/05 and benefiting around 120,000 customers (5% of the Company's network). Customer demand was again met without the need for hosepipe bans or drought orders.

REPORT OF THE DIRECTORS (Continued)

BUSINESS REVIEW (Continued)

Waste water investment expenditure totalled £84.5m. The Company's 15 year original 'Clean Sweep' coastal sewage treatment project has transformed the coastal environment around the South West. Bathing water compliance was at record levels in 2005 with 142 beaches (99.3%) meeting the Mandatory standard and 127 beaches (88.8%) meeting the tougher Guideline standard. This performance is supported by our operation of 52 UV treatment plants.

Financing

During the year the Directors decided to increase the level of gearing of the Company in order to increase the efficiency of the Company's capital structure. The following financial restructuring activities therefore took place:

- A special interim dividend of £200.0m was approved, of which £145.0m was paid on 15 March 2006, with the balance of £55.0m deferred until 31 May 2006.
- £20 was paid to each South West Water customer as a one-off payment, totalling £14.5m.
- Cash deposits of £178.9m, previously held under a defeased lease arrangement were released and utilised.
- A loan from the parent company of £150.0m was repaid on 17 January 2006 incurring redemption costs of £50.2m, including associated advisors' fees. This transaction matched the parent company's retirement of its 2012 £150.0m 10.625% Bonds on recommended terms supported by an ABI special committee.

Net debt increased in the year by £275.6m to £1,305.4m. The ratio of debt to Regulatory Capital Value (RCV) was circa 62% at 31 March 2006 (2005 52%), within Ofwat's 'optimum range' of 55% - 65%. The completion of the current financial restructuring with the payment of a £55.0m dividend on 31 May 2006 is expected to increase the debt to RCV ratio on a pro forma basis to circa 65%.

Significant funding facilities are in place to cover both medium and long term requirements, including finance leasing and loans from the European Investment Bank. In addition, short term facilities are in place with a range of financial institutions.

Short-term uncommitted facilities totalled £90.0m at 31 March 2006.

Derivatives, usually interest rate swaps, are used to manage the mix of fixed and floating rate debt. The notional principal amounts of the interest rate swaps are used to determine settlement under those swaps and do not, therefore, constitute an exposure for the Company.

The Directors confirm that the Company can meet its short term requirements from existing facilities without breaching covenants or other borrowing restrictions.

Dividends and reserves

The Company has established a dividend policy which involves the following components:

- a sustainable level of base dividend growth, determined by a number of factors including the shareholders' investment and the cost of capital.
- a further level of growth funded by efficiency out-performance.
- consistency with the assumptions made by Ofwat in setting prices for the five year period 2005 to 2010.

REPORT OF THE DIRECTORS (Continued)

BUSINESS REVIEW (Continued)

Dividend payments are designed to ensure that key financial ratios are not prejudiced and that the ability of the Appointee to finance its Appointed Business is not impaired.

In addition to an interim dividend of £52.9m (2005 £79.5m) paid to the parent undertaking in December 2005 a special interim dividend of £200.0m was approved in order to optimise the capital structure of the Company, of which £145.0m was paid on 15 March 2006, with the balance of £55.0m deferred until 31 May 2006. It is anticipated that an outperformance dividend in respect of 2005/06 will be paid in 2006/07.

Reserves at 31 March 2006 totalled £227.2m, a reduction of £206.9m on the figure at 31 March 2005 previously reported. Details of the movement are shown in note 25 to the financial statements on page 45. The reduction reflects the dividend payments as well as prior year adjustments on changes of accounting policy (particularly FRS 17 "Retirement Benefits") of £44.8m, profit after tax for the year and items posted directly to reserves.

Principal risks and uncertainties

The following are identified as the principal risks and uncertainties facing the Company:

- Price controls over the turnover of the Company's regulated business could adversely affect profitability.
- Failure to deliver the capital investment programme could adversely affect profitability.
- The Company may be unable to raise sufficient funds to finance its functions.
- Failure to deliver operating cost savings implicit in the regulatory review for the period 2005-2010 could adversely affect profitability.
- Environmental regulations and quality standards could increase the Company's costs and adversely affect profitability.
- Contamination to water supplies could adversely affect profitability.
- Non-recovery of customer debt could adversely affect profitability.

The Directors have established a formal framework for the identification and monitoring of both operational and financial risks arising from the Company's activities. The effectiveness of this framework is regularly reviewed by the Board.

Key Performance Indicators ("KPIs")

The principal KPIs used by the Directors to assess the performance and position of the business of the Company are as follows:

Growth in Regulatory Capital Value.

Regulatory Capital Value (RCV) is the financial base on which Ofwat allows a rate of return and sets prices. Each component within RCV is projected for each year by Ofwat at the 5 yearly Periodic Review. The RCV is adjusted annually for Retail Price Index movements. A full explanation is given in the Ofwat letter to Regulatory Directors RD08/06, which is available on the Ofwat website – www.ofwat.gov.uk. The RCV at 31 March 2006 is £2,091m compared to £1,890m at 31 March 2005, a growth of £201m (10.6%), reflecting a rebasing of the RCV as a result of the price determination for the period 2005-2010.

Operating Profit (before exceptional items).

Operating profit before exceptional items is used as a key measure of the performance of South West Water. The Company achieved an operating profit of £140.2m in 2005/06, up £14.4m (11.4%) on 2004/05.

REPORT OF THE DIRECTORS (Continued)

BUSINESS REVIEW (Continued)

Overall Performance Assessment.

Overall Performance Assessment (OPA) has been devised by Ofwat as a comparative tool to measure companies' performance. The OPA assigns scores to performance in areas such as customer service and complaint handling, billing, debt collection, asset serviceability, environmental compliance and quality of drinking water delivered. The data is collated for 12 month periods, part calendar year and part financial year and is usually published in the autumn. South West Water scored 395 points out of a maximum of 438 in 2004/05 and was joint sixth out of the 10 water and sewerage companies. This compares to a 2003/04 performance of 374 points out of 438 and a tenth position.

Drinking water compliance.

During 2005, South West Water improved its overall compliance with the drinking water quality regulations with 99.96% of its regulatory tests meeting the required standards.

Employees

Average employee numbers decreased during the year from 1,336 to 1,299, largely through the implementation of restructuring initiatives. Details of the number of employees and related costs can be found in note 8 to the financial statements on page 27.

Industrial relations and negotiating arrangements designed to meet business needs are in place. Employee consultation is maintained through a staff council and supporting consultative committees, both chaired by Directors of the Company, with representatives drawn from all functional areas.

A performance appraisal system exists for all non-manual staff and managers. The company uses financial incentivisation arrangements as appropriate to each group of workers and job satisfaction is supported by encouraging role changes wherever possible around the Company to help employees gain broad experience of business activities. All training activity is undertaken under the 'Investors in People' standard and is closely aligned with business requirements.

The Company as a 'good employer' has been introducing a number of 'Family Friendly' policies, which exceed statutory requirements. All employees are entitled to participate in a Pennon Group Sharesave Scheme and a Pennon Group Share Incentive Plan, both of which are all-employee plans where performance conditions do not apply.

Occupational health and safety remain key elements of South West Water's assessment of risk management. Following privatisation, the Company set out to build an occupational health and safety culture in partnership with a number of stakeholders including trade unions, regulators, other water companies and construction partners, which has been introduced into all parts of the supply chain. Training in skills acquisition and health and safety continues to ensure that employees have the knowledge and expertise to undertake their jobs to the best of their ability. In partnership with other water companies, South West Water leads 'Clear Water 2010', a national 10 year occupational health programme which has already demonstrated a significant reduction in work related ill health not reflected in other industrial sectors.

The Company remains committed to a non-discriminatory employment policy, making every reasonable effort to ensure that no current or future employee is disadvantaged because of age, gender, religion, colour, ethnic origin, marital status, sexual orientation or disability. In particular, the Company welcomes applications for employment from disabled persons and makes special arrangements and adjustments as necessary to ensure that disabled applicants are treated fairly when attending for interview or for pre-employment aptitude tests. Wherever possible, the opportunity is taken to retrain people who become disabled during their employment in order to maintain their employment within the Company.

REPORT OF THE DIRECTORS (Continued)

BUSINESS REVIEW (Continued)

Environment

The Company recognises the importance of its environmental responsibilities, monitors its impact on the environment, and designs and implements policies to reduce any damage that might be caused by its activities. The Company is subject to significant regulation and must comply with the high standards set by the Environment Agency. The Pennon Group has a long established environmental policy, as set out in its annual Corporate Responsibility Report which does not form part of this Report.

Payments to suppliers

It is the Company's payment policy for the year ending 31 March 2007 to follow the Code of The Better Payment Practice Group on supplier payments. The Company will agree payment terms with individual suppliers in advance and abide by such terms. Information about the Code may be obtained from The Better Payment Practice Group's website at www.payontime.co.uk. Trade creditors at 31 March 2006 represented 41 days of the amount invoiced by suppliers during the year.

Future developments

The key factor affecting the Company's performance over the next few years is the Periodic Review completed in December 2004 when Ofwat set water company charges for the years 2005-2010 giving 'K' price increases of 12.5%, 9.8%, 9.8%, 1.7%, 1.4% for 2005-2010 (an average of 6.9% p.a. over the five years). It also determined the investment outputs to be delivered by the Company over this period. The Company is confident that it can deliver the efficiency improvements assumed over this period and deliver the required investment programme.

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

DONATIONS

During the year, charitable donations amounting to £11,000 were made. No political donations were made.

RESEARCH AND DEVELOPMENT

The development and testing of innovative techniques and processes will continue to play a role in the further improvement of cost effective provision of services.

DIRECTORS

The current Directors of the Company are shown on page 5.

None of the Directors held any beneficial interest in the shares of the Company during the year. The interests of the Directors in shares of Pennon Group Plc are shown in note 10 of the Financial Statements. No Director has, or has had, a material interest, directly or indirectly, at any time during the year under review in any contract significant to the Company's business.

Bob Baty will retire on 31 July 2006. Chris Loughlin has been appointed as a Director and Chief Executive with effect from 1 August 2006.

REPORT OF THE DIRECTORS (Continued)

PARENT COMPANY

The Company is a wholly owned subsidiary of Pennon Group Plc.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

Company law requires the Directors to prepare financial statements for each financial year that give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. The Directors are required to prepare the financial statements on the going concern basis, unless it is inappropriate to presume that the company will continue in business.

The Directors confirm that suitable accounting policies have been used and applied consistently. They also confirm that reasonable and prudent judgements and estimates have been made in preparing the financial statements for the year ended 31 March 2006 and that applicable accounting standards have been followed.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities

STATEMENT AS TO DISCLOSURE OF INFORMATION TO AUDITORS

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

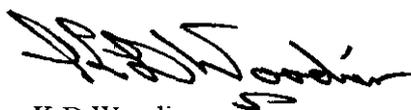
AUDITORS

A resolution to re-appoint PricewaterhouseCoopers LLP as auditors to the Company will be proposed at the annual general meeting. PricewaterhouseCoopers LLP have indicated their willingness to continue as auditors.

ANNUAL GENERAL MEETING

The sixteenth annual general meeting will be held at Peninsula House, Rydon Lane, Exeter on 18 July 2006 at 10.00 am.

By Order of the Board



K D Woodier
Secretary
Peninsula House
Rydon Lane
Exeter EX2 7HR

6 July 2006

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SOUTH WEST WATER LIMITED

We have audited the financial statements of South West Water Limited for the year ended 31 March 2006 which comprise the profit and loss account, the balance sheet, the cash flow statement, the statement of total recognised gains and losses, and the related notes. These financial statements have been prepared under the accounting policies set out therein.

Respective Responsibilities of Directors and Auditors

The Directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the statement of Directors' responsibilities.

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

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' report is consistent with the financial statements. We also report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and transactions is not disclosed.

We read other information contained in the Annual Report, and consider whether it is consistent with the audited financial statements. This other information comprises the Chief Executive's Review, the Report of the Directors and the Directors' Responsibility Statement. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of Audit Opinion

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

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SOUTH WEST WATER LIMITED (continued)

Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Company's affairs at 31 March 2006 and of its profit and cash flows for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.

A handwritten signature in black ink, appearing to read 'PricewaterhouseCoopers LLP', is written over a large, stylized letter 'P'.

PricewaterhouseCoopers LLP
Chartered Accountants
and Registered Auditors
Bristol

6 July 2006

PROFIT AND LOSS ACCOUNT
for the year ended 31 March 2006

| | Notes | 2006 | | | 2005 (restated) | | |
|--|-------|--------------------------------|----------------------------------|---------|--------------------------------|----------------------------------|---------|
| | | Before Exceptional items | Exceptional Items (note 4) | Total | Before Exceptional items | Exceptional Items (note 4) | Total |
| | | £m | £m | £m | £m | £m | £m |
| Turnover | 2 | 351.5 | - | 351.5 | 310.0 | - | 310.0 |
| Operating costs | 3 | (211.3) | (14.5) | (225.8) | (184.2) | (3.4) | (187.6) |
| Operating Profit | 2 | 140.2 | (14.5) | 125.7 | 125.8 | (3.4) | 122.4 |
| Net interest payable | 5 | (54.2) | (42.3) | (96.5) | (51.4) | - | (51.4) |
| Other finance cost | 22 | (0.1) | - | (0.1) | (1.2) | - | (1.2) |
| Profit on Ordinary Activities Before Taxation | 2 | 85.9 | (56.8) | 29.1 | 73.2 | (3.4) | 69.8 |
| Tax on profit on ordinary activities | 6 | (13.5) | 17.0 | 3.5 | (13.1) | 1.0 | (12.1) |
| Profit on Ordinary Activities After Taxation | | 72.4 | (39.8) | 32.6 | 60.1 | (2.4) | 57.7 |

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES
for the year ended 31 March 2006

| | Notes | 2006 £m | 2005 (restated) £m |
|---|-------|------------|--------------------------|
| Profit on Ordinary Activities After Taxation | | 32.6 | 57.7 |
| Actuarial gain recognised in the pension scheme | 22 | 1.8 | 1.3 |
| Movement on deferred tax relating to pension liability | 22 | (9.7) | 0.6 |
| Movement on hedging reserve | 25 | 0.4 | - |
| Total recognised gains for the year | | 25.1 | 59.6 |
| Adjustments on adoption of FRS 25 / 26 1 April 2005 (net of tax) | 27 | 8.8 | |
| Prior year adjustments | 27 | (43.8) | |
| Total losses recognised since last annual report | 27 | (9.9) | |

All operating activities are continuing operations.

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

The notes on pages 18 to 50 form part of these financial statements.

BALANCE SHEET
at 31 March 2006

| | Notes | 2006 £m | 2005 (restated) £m |
|--|-------|----------------|--------------------------|
| Fixed Assets | | | |
| Tangible assets | 11 | 2,164.1 | 2,051.1 |
| Investments | 12 | 5.3 | 5.2 |
| | | <u>2,169.4</u> | <u>2,056.3</u> |
| Current Assets | | | |
| Financial assets | | | |
| Derivative financial instruments | 19 | 2.5 | - |
| Stocks | 13 | 4.0 | 3.6 |
| Debtors: amounts falling due after more than one year | 14 | 1.5 | 1.0 |
| Debtors: amounts falling due within one year | 14 | 45.5 | 46.8 |
| Investments | 15 | 51.7 | 237.6 |
| Cash at bank and in hand | | 0.3 | 1.1 |
| | | <u>105.5</u> | <u>290.1</u> |
| Current Liabilities | | | |
| Creditors: amounts falling due within one year | 16 | (190.3) | (120.1) |
| Derivative financial instruments | 19 | (3.0) | - |
| Net Current Assets / (Liabilities) | | <u>(87.8)</u> | <u>170.0</u> |
| Total Assets Less Current Liabilities | | | |
| | | 2,081.6 | 2,226.3 |
| Creditors: amounts falling due after more than one year | | | |
| | 17 | (1,273.1) | (1,220.8) |
| Provisions for liabilities and charges | 20 | (88.2) | (83.5) |
| Deferred income | 21 | (18.1) | (34.1) |
| Net Assets Excluding Pension Liability | | <u>702.2</u> | <u>887.9</u> |
| Pension Liability | 22 | <u>(24.1)</u> | <u>(46.7)</u> |
| Net Assets Including Pension Liability | 2 | <u>678.1</u> | <u>841.2</u> |
| Capital and Reserves | | | |
| Called-up share capital | 23 | 450.9 | 450.9 |
| Reserves | 25 | 227.2 | 390.3 |
| Shareholders' Funds | 26 | <u>678.1</u> | <u>841.2</u> |

The notes on pages 18 to 50 form part of these financial statements.

Approved by the Board on 6 July 2006 and signed on its behalf by:-


R J Baty
Chief Executive


R M P Hughes
Finance & Regulatory Director

CASH FLOW STATEMENT
for the year ended 31 March 2006

| | Notes | 2006 £m | 2005 £m |
|---|-------|-----------------------|---------------|
| Net Cash Inflow from Operating Activities | 29a | 189.8 | 198.2 |
| Returns on Investments and Servicing of Finance | 29b | (96.6) | (46.5) |
| Taxation | | 2.7 | (3.2) |
| Capital Expenditure and Financial Investment | 29b | (167.9) | (134.8) |
| Equity Dividends Paid | | (197.9) | (79.5) |
| Cash Outflow Before Use of Liquid Resources and Financing | | <u>(269.9)</u> | <u>(65.8)</u> |
| Management of Liquid Resources | 29b | 216.2 | 19.0 |
| Financing | 29b | 71.3 | 52.8 |
| Increase in Cash in Year | 29c | <u>17.6</u> | <u>6.0</u> |

NOTES TO THE FINANCIAL STATEMENTS

1 Accounting Policies for the year ended 31 March 2006

These financial statements have been prepared under the historical cost convention, as modified by the revaluation of certain financial instruments, and in accordance with applicable accounting standards and, except for the treatment of grants and contributions on infrastructure assets, with the Companies Act 1985. An explanation of this departure from the requirements of the Companies Act 1985 is given in note 1(e) below. A summary of the more important accounting policies is set out below, together with an explanation of where changes have been made to previous policies on the adoption of new accounting standards in the year. These financial statements were approved by the Board of Directors on 6 July 2006.

Changes in accounting policies

The Company has adopted FRS 17 "Retirement Benefits", FRS 20 "Share-based payment", FRS 21 "Events after the balance sheet date", FRS 25 "Financial Instruments: Disclosure and Presentation" and FRS 26 "Financial Instruments: Measurement" in these financial statements. The adoption of each of these standards represents a change in accounting policy and the comparative figures have been restated accordingly except where the exemption to restate comparatives has been taken. Details of the effect of the prior year adjustments are given in note 27.

(a) Consolidated Financial Statements

The Company is exempt under the provisions of Section 228 of the Companies Act 1985 from the requirement to produce group financial statements (as amended by Section 5 of the Companies Act 1989) as it is a wholly-owned subsidiary undertaking of Pennon Group Plc which is registered within the European Economic Area and which itself prepares consolidated financial statements. Accordingly consolidated financial statements have not been prepared and the financial information presented is for the Company as an individual undertaking.

(b) Turnover

Turnover, excluding Value Added Tax, represents the income receivable in the ordinary course of business for services provided. Income from main water and waste water charges includes an estimation of the amount of unbilled charges at the period end based upon a defined methodology reflecting historical consumption and current tariffs.

(c) Tangible Fixed Assets and Depreciation

Tangible fixed assets comprise:-

- (i) infrastructure assets (being mains and sewers, impounding and pumped raw water storage reservoirs, dams, pipelines and sea outfalls)

Infrastructure assets comprise a network that, as a whole, is intended to be maintained in perpetuity at a specified level of service by the continuing replacement and refurbishment of its components.

Expenditure on infrastructure assets relating to increases in capacity or enhancements of the network, in accordance with defined standards of service, and to the maintenance of the operating capacity of the network, is treated as capital expenditure on tangible fixed assets and included at cost after deducting grants and contributions.

The depreciation charge on infrastructure assets represents the level of annual expenditure required to maintain the operating capacity of the network and is calculated from an independently certified asset management plan.

NOTES TO THE FINANCIAL STATEMENTS

1 Accounting Policies (Continued)

(c) Tangible Fixed Assets and Depreciation (continued)

(ii) other assets (including properties, overground plant and equipment)

Other assets are stated at cost less accumulated depreciation. Freehold land is not depreciated. Other assets are depreciated evenly over their estimated economic lives, which are principally as follows:-

| | |
|--------------------------------------|-------------|
| Buildings | 30-60 years |
| Operational properties | 40-80 years |
| Fixed plant | 20-40 years |
| Vehicles, mobile plant and computers | 3-10 years |

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

(d) Leased Assets

Assets held under finance leases are included in the balance sheet as tangible fixed assets at their equivalent capital value and are depreciated over their estimated economic lives or the finance lease period, whichever is the shorter. The corresponding liability is recorded as a creditor. The interest element of the rental cost is charged against profits, using the actuarial method, over the period of the lease.

At 31 March 2005 the rental obligations and cash deposits associated with defeased leases were recognised on the balance sheet separately and the net interest arising from these transactions was recognised over the life of the leases.

Rental costs arising under operating leases are charged against profits in the year they are incurred.

(e) Grants and Contributions

Grants and contributions receivable in respect of capital expenditure on non-infrastructure assets are included in the balance sheet as deferred income and are released to profits over the depreciable lives of the assets to which they relate.

Grants and contributions receivable relating to infrastructure assets are deducted from the cost of tangible fixed assets. This is not in accordance with the Companies Act 1985 which requires tangible fixed assets to be shown at cost and hence grants and contributions as deferred income. This departure from the requirements of the Companies Act 1985 is, in the opinion of the Directors, necessary for the financial statements to show a true and fair view as, while a provision is made for depreciation of infrastructure assets, these assets do not have determinable finite lives and therefore no basis exists on which to recognise grants and contributions as deferred income. The effect of this treatment on the value of tangible fixed assets is disclosed in note 11.

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

(f) Investments

Listed investments held as current assets are stated at the lower of cost and net realisable value.

Short-dated unlisted securities held as current assets are stated at cost plus accrued income.

NOTES TO THE FINANCIAL STATEMENTS

1 Accounting Policies (Continued)

(g) Stocks

Stocks are stated at the lower of cost and net realisable value. Cost includes labour, materials and an element of overheads.

(h) Pension Costs

The Company's employees are eligible to participate in funded defined benefit schemes, operated by the parent company.

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

Actuarial gains and losses arising from experience adjustments, changes in actuarial assumptions and amendments to pension plans are charged or credited to reserves and recorded in the Statement of Total Recognised Gains and Losses.

The adoption of FRS 17 "Retirement Benefits" has resulted in a change in the method of accounting for pension costs. The effect of this change is disclosed in note 27.

(i) Share-based payments

The Company operates a number of equity settled, share-based compensation plans for employees. The fair value of the employee services received 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 assumptions as to the number of awards which are expected to vest.

The Company has elected to adopt FRS 20 "Share-based payment" with effect from the year ended 31st March 2006. This has resulted in a change in the method of accounting for share-based payments. The effect of this change is disclosed in note 27.

(j) Research and Development Expenditure

Research and development expenditure is charged against profits in the year in which it is incurred.

NOTES TO THE FINANCIAL STATEMENTS

1 Accounting Policies (Continued)

(k) Taxation

Tax payable is provided on taxable profits at current rates. Tax deferred or accelerated as a result of timing differences between the treatment of certain items for taxation and for accounting purposes is provided for in full. Where the effect of the time value of money is material the current amount of the reversals of tax deferred or accelerated is discounted to its present value. The unwinding of the discount to present value is included in the tax charge. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that there will be suitable taxable profits against which the deferred tax asset can be recovered in future periods.

(l) Dividend distributions

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

The adoption of FRS 21 "Events after the balance sheet date" has resulted in a change to the method of accounting for dividend distributions. The effect of this change is disclosed in note 27.

(m) Derivatives and Other Financial Instruments

The Company has elected to adopt FRS 26 "Financial Instruments: Measurement" and FRS 25 "Financial Instruments: Disclosure and Presentation" with effect from 1 April 2005. It has taken advantage of the exemption in the standards not to restate comparative information.

The Company has classified its financial instruments in the following categories from 1 April 2005.

i) Loans and receivables

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

Gains and losses are recognised in the profit and loss account when the liabilities are derecognised or impaired. Premiums, discounts and other costs and fees are recognised in the profit and loss account through the amortisation process.

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

ii) Derivative financial instruments

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

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

NOTES TO THE FINANCIAL STATEMENTS

1 Accounting Policies (Continued)

(m) Derivatives and Other Financial Instruments (continued)

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

(iii) Trade debtors

Trade debtors do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts and the impact of discounting. The allowance for estimated irrecoverable amounts is calculated by applying expected recovery rates to debts outstanding at the end of the accounting period. The expected recovery rates take into account age of the debt, payment history and credit characteristics.

(iv) Trade creditors

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

n) Fair value estimates

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

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

o) Financial risk management

The Company receives treasury services from the treasury function of Pennon Group plc, the parent company which seeks to ensure that sufficient funding is available to meet foreseeable needs, maintains reasonable headroom for contingencies and manages interest rate risk.

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

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

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

(i) Interest rate risk

The Company has both interest bearing assets and interest bearing liabilities. The Company has a policy of maintaining at least 50% of interest bearing liabilities at fixed rates. At the year end 60% of net borrowings were at fixed rates. The Company uses a combination of fixed rate borrowings and fixed rate interest swaps as cash flow hedges of future variable interest payments to achieve this policy. 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 Company. In addition, a £142m finance lease was converted to an RPI-linked basis (1.365% real) during the year to take advantage of historically low index-linked rates and also to reduce earnings volatility. These instruments are analysed in more detail in note 19.

NOTES TO THE FINANCIAL STATEMENTS

1 Accounting Policies (Continued)

o) Financial risk management (continued)

(ii) Credit risk

The Company has no significant concentrations of credit risk.

(iii) Liquidity risk

The Company maintains a mixture of long-term and short-term committed facilities that are designed to ensure the Company has significant available funds for operations and planned expansions and facilities equivalent to at least one year's forecast requirements are maintained at all times. Details of undrawn committed facilities and short-term uncommitted facilities are provided in note 18.

iv) Refinancing risk management

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

v) Counterparty risk management

Counterparty risk arises from the investments of surplus funds and from the use of derivative instruments. The Board has agreed a policy for managing such risk, which is controlled through credit limits, counterparty approvals and rigorous monitoring procedures. Surplus funds of the Company are usually placed in short-term fixed interest deposits or the overnight money markets. All deposits are with counterparties that have credit ratings that are approved by the Board.

NOTES TO THE FINANCIAL STATEMENTS

2 Segmental Analysis

By class of business:-

| | Water | | Sewerage | | Company | |
|---|---------------|--------------------|---------------|--------------------|---------------|--------------------|
| | 2006 | 2005 (restated) | 2006 | 2005 (restated) | 2006 | 2005 (restated) |
| | £m | £m | £m | £m | £m | £m |
| Turnover | 153.1 | 133.4 | 198.4 | 176.6 | 351.5 | 310.0 |
| Profit | | | | | | |
| Segmental operating profit | 40.4 | 42.2 | 85.3 | 80.2 | 125.7 | 122.4 |
| Net interest payable & other finance charges | (39.0) | (20.7) | (57.6) | (31.9) | (96.6) | (52.6) |
| Profit on ordinary activities before taxation | 1.4 | 21.5 | 27.7 | 48.3 | 29.1 | 69.8 |
| Net Assets | 329.5 | 406.4 | 348.6 | 434.8 | 678.1 | 841.2 |

“Water” includes the provision of water resources, treatment and distribution services and “Sewerage” includes the transfer of sewage, its treatment and disposal.

An analysis by geographical origin and destination is not appropriate as the Company’s activity is substantially located in the United Kingdom.

3 Operating Costs

| | 2006 | 2005 (restated) |
|--------------------------------------|--------------|--------------------|
| | £m | £m |
| Manpower costs (note 8) | 31.8 | 33.6 |
| Raw materials and consumables | 12.8 | 11.6 |
| Rentals under operating leases:- | | |
| Hire of plant and machinery | 0.8 | 0.8 |
| Other operating leases | 1.3 | 1.3 |
| Research and development expenditure | 0.1 | 0.1 |
| Auditors’ remuneration | 0.1 | 0.2 |
| Other external charges | 71.2 | 60.4 |
| Depreciation:- | | |
| On owned non-infrastructure assets | 41.1 | 36.7 |
| On owned infrastructure assets | 18.2 | 12.9 |
| On assets held under finance leases | 21.7 | 19.0 |
| Profit on disposal of fixed assets | (1.4) | (1.2) |
| Deferred income released to profits | (1.3) | (1.3) |
| Other operating charges | 29.4 | 13.5 |
| | 225.8 | 187.6 |

No fees were payable to the Company’s auditors, PricewaterhouseCoopers LLP, for non-audit work in the current year. In the prior year £0.1m was payable in respect of assurance work in connection with the regulatory price review.

Other operating charges include the exceptional items of £14.5m (2005 £3.4m) set out in note 4 .

NOTES TO THE FINANCIAL STATEMENTS

4 Exceptional items

| | 2006 £m | 2005 £m |
|---|---------------|--------------|
| Profit on ordinary activities before taxation is after charging:- | | |
| Cost of redeeming loan from parent undertaking | (50.2) | - |
| Customer payment following financial restructuring | (14.5) | - |
| Consent fee on assignment of finance lease | 7.9 | - |
| Non-recurring restructuring costs | - | (3.4) |
| | <u>(56.8)</u> | <u>(3.4)</u> |

The cost of redeeming a loan from the parent undertaking represents the parent undertaking's cost of early redemption of a £150.0m bond, including associated advisers' fees.

5 Net Interest Payable

| | 2006 £m | 2005 £m |
|--|----------------|---------------|
| Interest payable:- | | |
| To parent undertaking | (63.0) | (15.9) |
| Bank loans and overdrafts | (16.7) | (16.5) |
| Interest element of finance lease rentals | (38.7) | (32.2) |
| Other finance costs | (12.4) | (12.1) |
| | <u>(130.8)</u> | <u>(76.7)</u> |
| Interest receivable:- | | |
| From parent undertaking | 1.2 | 2.1 |
| From fellow subsidiaries | 0.1 | 0.1 |
| Consent fee on assignment of finance lease | 7.9 | - |
| Other finance income | 13.9 | 11.7 |
| Other investments (as defined in note 15) | 11.2 | 11.4 |
| | <u>34.3</u> | <u>25.3</u> |
| Net interest payable | <u>(96.5)</u> | <u>(51.4)</u> |

Interest payable to parent undertaking includes an exceptional item of £50.2m (2005 £Nil) and interest receivable includes an exceptional item of £7.9m (2005 £Nil) set out in note 4.

NOTES TO THE FINANCIAL STATEMENTS

6 Tax on Profit on Ordinary Activities

| | 2006 £m | 2005 £m |
|--|---------------|-------------|
| (a) Analysis of charge for year | | |
| Current tax : | | |
| UK corporation tax at 30% :- | | |
| Current year | 1.6 | 5.6 |
| Prior year | (11.2) | (3.5) |
| Amounts receivable from Pennon Group companies in respect of surrender of taxable losses and advance corporation tax | (0.6) | - |
| Total current tax (note 6 (b)) | <u>(10.2)</u> | <u>2.1</u> |
| Deferred tax : | | |
| Origination and reversal of timing differences | 13.6 | 17.4 |
| Increase in discount | (6.9) | (7.4) |
| Total deferred tax (note 20) | <u>6.7</u> | <u>10.0</u> |
| Tax on profit on ordinary activities | <u>(3.5)</u> | <u>12.1</u> |

| | 2006 £m | 2005 (restated) £m |
|---|------------|--------------------------|
| (b) Factors affecting current tax charge for the year | | |

The tax assessed for the year is lower than the standard rate of corporation tax in the UK (30%)

The differences are explained below:

| | | |
|--|---------------|-------------|
| Profit on ordinary activities before tax | <u>29.1</u> | <u>69.8</u> |
| Profit on ordinary activities multiplied by standard rate of corporation tax in the UK (30%) | 8.7 | 20.9 |
| Tax effects of: | | |
| Expenses not deductible for tax purposes | 0.3 | 0.3 |
| Income received not taxed | (0.8) | - |
| Capital allowances for year in excess of depreciation | (3.8) | (16.0) |
| Other timing differences | (2.8) | 0.4 |
| Adjustments to tax charge in respect of prior year | (11.8) | (3.5) |
| Current tax charge for the year (note 6(a)) | <u>(10.2)</u> | <u>2.1</u> |

NOTES TO THE FINANCIAL STATEMENTS

7 Dividends

| | 2006 £m | 2005 £m |
|---|--------------|-------------|
| Interim dividend of 11.73p (2005 17.62p) per Ordinary share paid 12 December 2005 | 52.9 | 79.5 |
| Special interim dividend | <u>145.0</u> | <u>-</u> |
| | <u>197.9</u> | <u>79.5</u> |

On 23 February 2006, in order to optimise the capital structure of the Company, the Directors approved payment of an interim dividend of 44.35p per Ordinary share totalling £200.0m. £145.0m was paid on 15 March 2006 with the balance of £55.0m deferred until 31 May 2006 when it was paid.

8 Employees and Employment Costs

The average number of persons (including Directors) employed by the Company was:-

| | 2006 | 2005 |
|-------------------|--------------|--------------|
| Water services | 662 | 686 |
| Sewerage services | 637 | 650 |
| | <u>1,299</u> | <u>1,336</u> |

| | 2006 £m | 2005 (restated) £m |
|---|-------------|--------------------------|
| Employment costs comprise:- | | |
| Wages and salaries | 33.7 | 33.3 |
| Social security costs | 2.6 | 2.5 |
| Pension costs (note 22) | 6.8 | 6.3 |
| Charge / (release) of pension costs to / (from) restructuring provision | (0.7) | 1.3 |
| Total employment costs | <u>42.4</u> | <u>43.4</u> |
| Charged as follows:- | | |
| Manpower costs (note 3) | | |
| Before exceptional costs | 31.8 | 30.6 |
| Exceptional costs (note 4) | - | 3.0 |
| | <u>31.8</u> | <u>33.6</u> |
| Restructuring | 0.6 | - |
| Capital schemes | 10.0 | 9.8 |
| | <u>42.4</u> | <u>43.4</u> |

NOTES TO THE FINANCIAL STATEMENTS

9 Directors' Remuneration

Directors' remuneration for year ended 31 March 2006:

| | Salary | Performance† (see below) | Other | Total |
|--------------|------------|-----------------------------|-----------|------------|
| | £000 | £000 | £000 | £000 |
| R J Baty* | 168 | 52 | 12 | 232 |
| S C Bird | 110 | 23 | 11 | 144 |
| R M P Hughes | 100 | 23 | 10 | 133 |
| M S Read | 71 | 16 | 10 | 97 |
| | <u>449</u> | <u>114</u> | <u>43</u> | <u>606</u> |

Directors' remuneration for the year ended 31 March 2005 comprised salary of £428,000, performance related bonus of £131,000 and other emoluments of £42,000.

Other emoluments include car benefit and health care.

* The Chief Executive, R J Baty is a director of Pennon Group Plc and part of his service is attributable to that company. His total remuneration is disclosed in the accounts of that company and included above is the proportion of his total remuneration deemed attributable to his service as an executive director of South West Water.

† The above performance related payments against standards represent the cash element. In addition, Directors received a conditional award of shares in Pennon Group Plc for a matching value which is subject to future service criteria. Mr Baty waived the cash element of his performance related bonus in 2004/05 which amounted to £59,000.

At 31 March, retirement benefits were accruing to 4 Directors (2005 4 Directors) under defined benefit pension schemes operated by the parent company.

The highest paid Director participated in defined benefit pension schemes with an accrued annual pension of £126,000 at 31 March 2006 (2005 £118,000).

Details of the awards given under the Pennon Group Long-term Incentive Plan and the Pennon Group Performance Related Bonus Plan are shown in note 10.

The Chairman, K G Harvey, is a director of Pennon Group Plc and his remuneration is disclosed in the accounts of that company.

Background

Directors of South West Water have their remuneration and terms of employment determined by the Remuneration Committee ('the Committee') of Pennon Group Plc, the ultimate holding company. Further details of the operation of this Committee can be found in the financial statements of Pennon Group Plc.

Elements of Remuneration

The remuneration of the Directors comprises salary, payments related to performance against agreed standards, long term incentives, pensions, car benefit and health cover.

NOTES TO THE FINANCIAL STATEMENTS

9 Directors' Remuneration (continued)

Payments related to performance against agreed standards

As required by the Water Act 2003 and Regulatory Accounting Guidance from the Water Services Regulation Authority (Ofwat), additional information is given regarding this aspect of remuneration.

For the year 2005/06 cash payments in respect of service as executive directors of South West Water Limited are, expressed as a percentage of salary up to a maximum of 30%, as follows:

- i. Based on an estimate of the Overall Performance Assessment points to be awarded by Ofwat for 2005/06 0.5% up to a maximum of 5% for each position above 10th compared to the published scores for 2004/05 for the water and sewerage companies. This reflects the importance South West Water attaches to all round performance.
- ii. Up to a maximum of 5% in relation to a series of discrete individual Director's targets for performance on Ofwat DG measures, pollution and waste water measures set up by the Environment Agency, drinking water compliance and level of customer debt. Performance under each of these standards reflects customer and stakeholder measures.
- iii. A 2% bonus for each 0.5% outperformance of South West Water against its operating cost budget up to a maximum of 10%. Cost control and efficiency are key factors in South West Water's long term performance.
- iv. a 1% bonus for every 1% that profit before tax is higher than budget up to a maximum of 5%. Profit before tax is a key measure of performance.
- v. a 2% bonus for each 1% saving against budgeted net debt up to a maximum of 5%. The purpose is to demonstrate strong cash management.

These arrangements were approved by the Remuneration Committee of Pennon Group Plc on 25 May 2005.

Awards made under the Long-term Incentive Plan are linked to the Total Shareholder Return of the Pennon Group Plc only. Further details are given in the financial statements of that company.

Payments relating to agreed performance against agreed standards for the year ended 31 March 2006 amounted to:

| | Individual Service Standards £000 | Operating Costs £000 | Profit Before Tax £000 | Net Debt £000 | Total £000 |
|--------------|--|----------------------------|------------------------------|------------------|---------------|
| R J Baty* | 4.8 | 13.6 | 8.4 | 8.4 | 35.2 |
| S C Bird | 3.2 | 9.0 | 5.5 | 5.5 | 23.2 |
| R M P Hughes | 4.4 | 8.1 | 5.0 | 5.0 | 22.5 |
| M S Read | 3.2 | 5.8 | 3.6 | 3.6 | 16.2 |
| | 15.6 | 36.5 | 22.5 | 22.5 | 97.1 |

No payments were due under the Overall Performance Assessment criteria.

* R J Baty also received an amount of £21,000 relating to earnings per share performance of Pennon Group Plc, of which £16,800 was apportioned to the Company.

As set out above, Directors receive a conditional award of shares for a matching value which is subject to future service criteria.

NOTES TO THE FINANCIAL STATEMENTS

10 Directors' Interests

No Director has held any beneficial interest in the shares of the Company during the year.

Messrs K G Harvey and R J Baty are Directors of Pennon Group Plc and their interests in the shares of Pennon Group Plc are disclosed in the financial statements of that company.

The interests of the other Directors holding office at 31 March 2006 in the shares of Pennon Group Plc at 31 March 2006 and 31 March 2005 were:

(a) Shareholdings

| | 2006 Deferred Shares† (110p each) | 2006 B Shares** (110p each) | 2006 Ordinary Shares (122 1/10 each) | 2005 Ordinary Shares (£1.11 p each)* |
|--------------|---|-----------------------------------|--|--|
| S C Bird | - | 10,500 | 4,510 | 4,590 |
| R M P Hughes | 27,306 | 6,000 | 8,565 | 6,753 |
| M S Read | 7,200 | 8,808 | 5,369 | 6,276 |

* The Ordinary Shares of £1.11 each at the close of business on 17 February 2006 were subject to a share capital consolidation, which resulted in every 11 of the existing Ordinary Shares of £1.11 each being replaced by 10 new Ordinary shares of 122 1/10p each.

† B Shares were converted into Deferred Shares upon shareholders electing to take the B Share dividend of 110p per B Share on 27 February 2006 pursuant to the B Share Scheme approved by shareholders of Pennon Group Plc at an Extraordinary General Meeting on 15 February 2006 as part of a return of cash to shareholders. The Deferred Shares were all redeemed by Pennon Group Plc on 6 April 2006 pursuant to the provisions of the B Share Scheme. The Directors received no payment for the redemption of these shares.

** The remaining B shares held by the Directors were redeemed on 6 April 2006 at 110p each in accordance with the provisions of the B Share Scheme.

(b) Sharesave Scheme

Options to subscribe for shares in Pennon Group Plc under the all-employee Sharesave Scheme were:

| | Options over Ordinary Shares | | | | |
|--------------|------------------------------|----------------------|------------------------|---------------------|------------------|
| | 31 March 2006 | Granted in Period | Exercised in Period | Lapsed In Period | 31 March 2005 |
| S C Bird | 1,460 | 467 | 671 | - | 1,664 |
| R M P Hughes | 1,745 | - | - | - | 1,745 |
| M S Read | 2,721 | 816 | 1,464 | - | 3,369 |

(c) Long Term Incentive Plan

In addition to the above beneficial interests, the Directors had a contingent interest in the shares of Pennon Group Plc under the terms of the Pennon Group Long Term Incentive Plan, described in note 24, as follows:

| | Contingent interest in Ordinary Shares | | | | |
|--------------|--|----------------------|---------------------|---------------------|------------------|
| | 31 March 2006† | Granted in Period | Vested in Period | Lapsed In Period | 31 March 2005 |
| S C Bird | 15,690 | 6,182 | 2,914 | 2,914 | 16,906 |
| R M P Hughes | 17,885 | 5,593 | 3,761 | 3,761 | 21,605 |
| M S Read | 12,802 | 4,003 | 2,445 | 2,445 | 14,970 |

† The number of shares in the awards outstanding as at 31 March 2006 has been reduced to the number shown (in the ratio of 10 for 11) consequent upon the Pennon Group Plc's share capital consolidation on 17 February 2006.

NOTES TO THE FINANCIAL STATEMENTS

10 Directors' Interests (Continued)

The above represent the maximum number of shares to which the Directors would become entitled if all relevant criteria are met. The awards vested during the year at a price of 1067p per share. No awards are due to vest in 2006/07.

During the year the Directors received dividends on the above shares in accordance with the conditions of the Long Term Incentive Plan. In addition, the Directors received a B Share in respect of each of the above shares in accordance with the Pennon Group Plc B Share Scheme and either upon their election received a dividend of 110p in respect of each of the B Shares (whereupon they became Deferred Shares of nil value to the Director) or they redeemed the shares for 110p each (or a combination of each option).

(d) Performance Related Bonus Plan

The Directors also had a contingent interest in the shares of Pennon Group Plc under the terms of the Pennon Group Performance Related Bonus Plan, described in note 24, as follows :

| | Contingent interest in Ordinary Shares | | | | |
|--------------|--|----------------------|---------------------|---------------------|------------------|
| | 31 March 2006† | Granted in Period | Vested in Period | Lapsed In Period | 31 March 2005 |
| S C Bird | 6,470 | 2,849 | 3,454 | - | 7,723 |
| R M P Hughes | 5,735 | 2,577 | 2,051 | - | 5,784 |
| M S Read | 4,291 | 1,865 | 685 | - | 3,541 |

† The number of shares in the awards outstanding as at 31 March 2006 has been reduced to the number shown (in the ratio of 10 for 11) consequent upon the Pennon Group Plc's share capital consolidation on 17 February 2006.

The above represent the maximum number of shares to which the Directors would usually become entitled if they remain employed by the Pennon Group for a further three years from the date of the awards. The awards vested during the year at a price of 1021p per share. It is anticipated that all the shares will vest under the 2003 awards as the service criteria are expected to be met.

During the year the Directors received dividends on the above shares in accordance with the conditions of the Performance Related Bonus Plan. In addition, the Directors received a B share in respect of each of the above B Shares in accordance with the Pennon Group Plc B Share scheme and either upon their election received a dividend of 110p in respect of each of the B Shares (whereupon they became Deferred Shares of nil value to the Director) or they redeemed the shares for 110p each (or a combination of each option).

A further conditional award of shares will be made in 2006/07 to match the amount of the cash bonus shown in Note 9.

The changes in the Directors' interests in the shares of Pennon Group Plc since 31 March 2006 are as follows:

On 13 April 2006, Mrs Read acquired 17 shares as a result of re-investing some of her 2005/06 interim dividend into an ISA.

On 5 June 2006, Mr Hughes sold 1,200 shares.

On 19 June 2006, 9 shares were purchased on behalf of Mrs Read in connection with the Pennon Group Share Incentive Plan.

NOTES TO THE FINANCIAL STATEMENTS

11 Tangible Fixed Assets

| | Freehold land and buildings | Infra- structure assets | Opera- tional properties | Fixed & mobile plant, vehicles and computers | Construc- tion in progress | Total |
|-------------------------------|-----------------------------------|-------------------------------|--------------------------------|---|----------------------------------|----------------|
| | £m | £m | £m | £m | £m | £m |
| Cost:- | | | | | | |
| At 1 April 2005 | 12.7 | 1,163.1 | 568.0 | 846.8 | 71.5 | 2,662.1 |
| Additions | 0.8 | 61.0 | 3.5 | 33.7 | 98.6 | 197.6 |
| Grants and contributions | - | (1.2) | - | - | - | (1.2) |
| Transfers / reclassifications | 1.2 | 25.0 | 12.3 | 29.7 | (68.2) | - |
| Disposals | (0.8) | (0.7) | (5.8) | (62.0) | - | (69.3) |
| At 31 March 2006 | 13.9 | 1,247.2 | 578.0 | 848.2 | 101.9 | 2,789.2 |
| Depreciation:- | | | | | | |
| At 1 April 2005 | 3.9 | 141.4 | 122.1 | 343.6 | - | 611.0 |
| Charge for year | 0.2 | 21.2 | 10.8 | 50.2 | - | 82.4 |
| Disposals | (0.3) | (0.7) | (5.8) | (61.5) | - | (68.3) |
| At 31 March 2006 | 3.8 | 161.9 | 127.1 | 332.3 | - | 625.1 |
| Net Book Value:- | | | | | | |
| At 31 March 2006 | 10.1 | 1,085.3 | 450.9 | 515.9 | 101.9 | 2,164.1 |
| At 31 March 2005 | 8.8 | 1,021.7 | 445.9 | 503.2 | 71.5 | 2,051.1 |

Out of the total depreciation charge for the Company of £82.4m (2005 £70.0m), the sum of £1.4m (2005 £1.4m) has been charged to capital projects, and £81.0m (2005 £68.6m) against profits.

The cost of freehold land and buildings and operational properties includes non-depreciable land of £2.6m (2005 £2.2m) and £9.3m (2005 £9.3m) respectively.

The net book value of infrastructure assets is stated after deducting £51.0m (2005 £49.8m) grants and contributions.

NOTES TO THE FINANCIAL STATEMENTS

11 Tangible Fixed Assets (Continued)

Maintenance of the operating capability of the infrastructure network:-

| | £m |
|--|-----------|
| Excess of expenditure over depreciation on maintaining the operating capability of the network at 1 April 2005 | 13.8 |
| Expenditure in the year on maintaining operating capability | 18.2 |
| Less depreciation for the year | (21.2) |
| | <hr/> |
| Excess of expenditure over depreciation at 31 March 2006 | 10.8 |
| | <hr/> |

Assets held under finance leases included above:-

| | Infra- structure assets | Opera- tional properties | Fixed & mobile plant, vehicles and computers | Construc- tion in progress | Total |
|---------------------------------|-------------------------------|--------------------------------|---|----------------------------------|--------------|
| | £m | £m | £m | £m | £m |
| Cost:- At 31 March 2006 | 188.2 | 318.8 | 234.5 | 147.2 | 888.7 |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Depreciation:- Charge for year | 3.0 | 5.6 | 13.1 | - | 21.7 |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Depreciation:- At 31 March 2006 | 13.7 | 54.6 | 114.2 | - | 182.5 |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |

12 Fixed Asset Investments

| | Joint Venture | Subsidiary Undertakings | Listed Investments | Total Investments 2005 |
|----------------------------|------------------|----------------------------|-----------------------|---------------------------------------|
| | £m | £m | £m | £m |
| At 1 April 2005 (restated) | 0.1 | 3.3 | 1.8 | 5.2 |
| Additions during year | - | - | 0.9 | 0.9 |
| Provision for impairment | - | - | (0.8) | (0.8) |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| At 31 March 2006 | 0.1 | 3.3 | 1.9 | 5.3 |
| | <hr/> | <hr/> | <hr/> | <hr/> |

The listed investments relate to a Long Term Incentive Plan and a Performance Related Bonus Plan, both operated for senior management of the Company. Further details of the operation of these share schemes are set out in note 24. The shares in the schemes are released out of an Employee Share Ownership Plan, a discretionary trust, established to facilitate the operation of the incentive schemes, and are held on the balance sheet until such time as they vest unconditionally.

The costs of the Long Term Incentive Plan and the Performance Related Bonus Plan (the fair value of the employee services received in exchange for the grant) are recognised as a provision for impairment and charged within employment costs over the vesting period of the grant.

NOTES TO THE FINANCIAL STATEMENTS

12 Fixed Asset Investments (Continued)

The Company holds 99,999 (100%) A ordinary shares in Echo South West Limited, a joint venture engaged in customer contact management, established between the Company and Echo Managed Services Limited, a subsidiary of South Staffordshire Group Plc. The proportion of the nominal value of ordinary shares held by the Company remains at 50%.

The Company has two wholly-owned subsidiaries, Peninsula Properties (Exeter) Limited and Peninsula Leasing Limited. Both companies are incorporated, registered and have their operation in England.

Consolidated financial statements have not been prepared, as explained in note 1(a).

In the opinion of the Directors the total value of investments in subsidiary and joint venture undertakings is not less than the amount at which they are shown in the balance sheet.

13 Stocks

| | 2006 £m | 2005 £m |
|-------------------------------|------------|------------|
| Raw materials and consumables | 4.0 | 3.6 |

14 Debtors

| | 2006 £m | 2005 £m |
|--|-------------|-------------|
| Amounts falling due after more than one year:- | | |
| Amounts owed by fellow subsidiary undertakings | 1.4 | 0.8 |
| Amounts owed by joint venture | 0.1 | 0.2 |
| | <u>1.5</u> | <u>1.0</u> |
| Amounts falling due within one year:- | | |
| Trade debtors | 38.2 | 42.0 |
| Less: provision for impairment of receivables | (24.4) | (19.4) |
| | <u>13.8</u> | <u>22.6</u> |
| Amounts owed by fellow subsidiary undertakings | 0.7 | 0.9 |
| Corporation Tax | 4.7 | - |
| Amounts owed by joint venture | 1.2 | 1.2 |
| Other debtors | 3.7 | 3.8 |
| Prepayments and accrued income | 21.4 | 18.3 |
| | <u>45.5</u> | <u>46.8</u> |

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

NOTES TO THE FINANCIAL STATEMENTS

15 Current Asset Investments

| | 2006 £m | 2005 £m |
|---------------------|-------------|--------------|
| Other investments:- | | |
| Overnight deposits | 51.7 | 20.4 |
| Other | - | 217.2 |
| | <u>51.7</u> | <u>237.6</u> |

During the year restricted deposited funds of £177.1m as at 31 March 2005, used to counter-indemnify letters of credit by financial institutions to lessors in order to secure rental obligations, were released (note 18).

The effective interest rate on short-term deposits was 4.7% and these deposits had an average maturity of 3 days.

16 Creditors: Amounts Falling Due Within One Year

| | 2006 £m | 2005 (restated) £m |
|--|--------------|--------------------------|
| Loans:- (note 18) | | |
| European Investment Bank loans | 4.2 | 14.7 |
| Bank loans and overdrafts | 55.7 | 7.8 |
| | <u>59.9</u> | <u>22.5</u> |
| Obligations under finance leases (note 18) | 24.4 | 25.2 |
| Trade creditors | 15.2 | 11.8 |
| Capital creditors | 54.0 | 29.8 |
| Other amounts owed to parent undertaking | 2.3 | 2.4 |
| Other amounts owed to joint venture | 0.2 | 0.2 |
| Amounts owed to fellow subsidiary undertakings | 0.4 | 0.8 |
| Other creditors | 5.5 | 7.7 |
| Corporation Tax | 4.4 | 2.1 |
| Other taxation and social security | 1.0 | 1.0 |
| Accruals and deferred income | 23.0 | 16.6 |
| | <u>190.3</u> | <u>120.1</u> |

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

17 Creditors: Amounts Falling Due After More Than One Year

| | 2006 £m | 2005 £m |
|--|----------------|----------------|
| Loans:- (note 18) | | |
| European Investment Bank loans | 232.2 | 166.4 |
| Other loans | 120.0 | 120.0 |
| Amounts owed to parent undertaking | - | 150.0 |
| | <u>352.2</u> | <u>436.4</u> |
| Obligations under finance leases (note 18) | 920.9 | 784.4 |
| | <u>1,273.1</u> | <u>1,220.8</u> |

NOTES TO THE FINANCIAL STATEMENTS

18 Loans and Other Borrowings

| | 2006 £m | 2005 £m |
|--|--------------|--------------|
| Loans | | |
| Repayable:- | | |
| Over five years | 173.6 | 267.7 |
| Over two and up to five years | 162.3 | 124.5 |
| Over one and up to two years | 16.3 | 44.2 |
| Falling due after more than one year (note 17) | <u>352.2</u> | <u>436.4</u> |
| Falling due within one year (note 16) | <u>59.9</u> | <u>22.5</u> |
| | <u>412.1</u> | <u>458.9</u> |
| | 2006 £m | 2005 £m |
| Obligations under finance leases | | |
| Repayable:- | | |
| Over five years | 828.2 | 708.7 |
| Over two and up to five years | 64.8 | 51.6 |
| Over one and up to two years | 27.9 | 24.1 |
| Falling due after more than one year (note 17) | <u>920.9</u> | <u>784.4</u> |
| Falling due within one year (note 16) | <u>24.4</u> | <u>25.2</u> |
| | <u>945.3</u> | <u>809.6</u> |

Included above are accrued finance charges arising on obligations under finance leases totalling £108.2m (2005 £104.6m), of which £23.9 m (2005 £22.6m) is repayable within one year.

Loans and obligations under finance leases

Included above are instalment debts, of which any part falls due for payment after five years, and non-instalment debts due after five years:-

| | 2006 £m | 2005 £m |
|----------------------------------|----------------|----------------|
| Loans | 230.0 | 310.0 |
| Obligations under finance leases | 944.3 | 808.9 |
| | <u>1,174.3</u> | <u>1,118.9</u> |

NOTES TO THE FINANCIAL STATEMENTS

18 Loans and Other Borrowings (Continued)

The Directors consider that the carrying amounts of borrowings falling due within one year approximate to their fair value.

The fair value of the borrowings falling due after more than one year are:

| | 2006 | |
|----------------------------------|---------------------|---------------------|
| | Book value £m | Fair value £m |
| European Investment Bank | 232.2 | 226.9 |
| Bank loans | <u>120.0</u> | <u>120.0</u> |
| | 352.2 | 346.9 |
| Obligations under finance leases | <u>920.9</u> | <u>878.7</u> |
| | <u>1,273.1</u> | <u>1,225.6</u> |

The exposure to interest rate changes and the repricing dates at the balance sheet date are:

| | 2006 £m | 2005 £m |
|------------------|----------------|----------------|
| 6 months or less | 264.1 | 220.1 |
| 6 – 12 months | 141.0 | 245.6 |
| 1 – 5 years | 847.3 | 547.8 |
| Over 5 years | <u>105.0</u> | <u>255.0</u> |
| | <u>1,357.4</u> | <u>1,268.5</u> |

The effective interest rates at the balance sheet date were:

| | 2006 % | 2005 % |
|--------------------------------|-----------|-----------|
| Bank overdrafts | 5.5 | 5.8 |
| European Investment Bank loans | 4.7 | 5.5 |
| Loan from parent undertaking | - | 10.6 |
| Bank loans | 4.9 | 5.3 |
| Finance leases | 3.8 | 3.9 |

The Company has undrawn committed borrowing facilities:

| | 2006 £m | 2005 £m |
|--------------------------|--------------|--------------|
| Floating rate: | | |
| Expiring within one year | 50.0 | - |
| Expiring after one year | <u>110.0</u> | <u>215.0</u> |
| | <u>160.0</u> | <u>215.0</u> |

NOTES TO THE FINANCIAL STATEMENTS

18 Loans and Other Borrowings (Continued)

In addition, the Company has short-term uncommitted bank facilities of £90.0m (2005 £115.0m).

Within obligations under finance leases the company has utilised finance lease facilities of £180.0m for certain water and sewerage services tangible fixed assets and had at 31 March 2005 deposited amounts, equal to the present value of rental obligations arising from those finance leases, with United Kingdom financial institutions, to counter-indemnify letters of credit issued by those institutions to the lessors in order to secure those rental obligations.

During the year, these deposited funds, which at 31 March 2005 totalled £177.1m (including interest earned) were released. The existing bank letters of credit, covering the full period of the finance leases, remain in place, but are renewable between the financial institutions and the Company at five-yearly intervals, the next being March 2011.

19 Derivative Financial Instruments

Numerical financial instruments disclosures are set out below. Additional disclosures are set out in the accounting policies relating to financial risk management and also in notes 18 and 25.

| | Assets £m | Liabilities £m |
|---------------------|--------------|-------------------|
| At 31 March 2006 | | |
| Interest rate swaps | 2.5 | (3.0) |
| | <u>2.5</u> | <u>(3.0)</u> |

Interest rate swaps and fixed rate borrowings are used to manage the mix of fixed and floating rates to ensure at least 50% of net borrowings is at fixed rate.

At 31 March 2006 60% of net borrowings was at fixed rate.

At 31 March 2006 interest rate swaps to hedge financial liabilities with a notional principal value of £626.0m existed, with a weighted average maturity of 3.5 years to swap from floating to fixed rate. The weighted average interest rate of the swaps was 4.9%.

At 31 March 2004 floating rate interest swaps, to hedge financial liabilities with a notional principal of £200.0m, existed to swap LIBOR to European Inter Bank Offer Rate (EURIBOR) with commencement dates between 1 April 2006 and 1 April 2010, and maturing on 31 March 2030. A settlement of £18.2m which was received when these swaps were entered into during December 1999 was deferred (note 21). In May 2004 these interest rate swaps were terminated through the payment of £3.4m. The net balance of monies received of £14.8m was released to reserves on adoption of FRS 26 on 1 April 2005.

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

NOTES TO THE FINANCIAL STATEMENTS

20 Provisions for Liabilities and Charges

| | Restructuring £m | Deferred Tax £m | Total £m |
|----------------------------|---------------------|-----------------------|-------------|
| At 1 April 2005 (restated) | 2.7 | 80.8 | 83.5 |
| Charged against profits | 0.9 | 6.7 | 7.6 |
| Credit to reserves | - | (0.6) | (0.6) |
| Utilised during year | (2.3) | - | (2.3) |
| At 31 March 2006 | <u>1.3</u> | <u>86.9</u> | <u>88.2</u> |

The restructuring provision relates to severance costs to be utilised over the next twelve months.

Deferred Taxation

| | 2006 £m | 2005 (restated) £m |
|---|--------------|--------------------------|
| Accelerated capital allowances | 315.0 | 297.5 |
| Other timing differences | (7.8) | (3.3) |
| Undiscounted provision for deferred tax | <u>307.2</u> | <u>294.2</u> |
| Discount | (220.3) | (213.4) |
| Discounted provision for deferred tax | <u>86.9</u> | <u>80.8</u> |
| Provision at 1 April 2005 (restated) | 80.8 | |
| Deferred tax charge in profit and loss account for year | 6.7 | |
| Credit to reserves | (0.6) | |
| Provision at 31 March 2006 | <u>86.9</u> | |

NOTES TO THE FINANCIAL STATEMENTS

21 Deferred Income

| | Forward interest rate swap £m | Grants and contributions £m | Total £m |
|---|--|-----------------------------------|--------------|
| At 1 April 2005: | | | |
| Amount to be released : | | | |
| after more than one year | 14.8 | 19.3 | 34.1 |
| within one year | - | 1.3 | 1.3 |
| | <u>14.8</u> | <u>20.6</u> | <u>35.4</u> |
| Additions / (repayments) | - | - | - |
| Released on adoption of FRS 26 1 April 2005 | (14.8) | - | (14.8) |
| Released to profits | - | (1.3) | (1.3) |
| | <u>-</u> | <u>(1.3)</u> | <u>(1.3)</u> |
| At 31 March 2006: | - | 19.3 | 19.3 |
| Amount to be released: | | | |
| within one year | - | (1.2) | (1.2) |
| after more than one year | - | 18.1 | 18.1 |
| | <u>-</u> | <u>18.1</u> | <u>18.1</u> |

22 Pensions

The Company's employees are eligible to participate in funded defined benefit schemes, operated by the parent company. The assets of the Group's pension schemes are held in separate trustee administered funds.

The full actuarial valuation at 1 April 2004 was updated at 31 March 2006 by the independent qualified actuary using the projected unit method. The value of the schemes' assets has been updated to market value as at 31 March 2006. The demographic assumptions used in calculating the scheme liabilities remain unchanged from those used in the 1 April 2004 actuarial valuation. The financial assumptions used by the actuary at each year end were as follows:

| | 2006 % | 2005 % | 2004 % |
|--|-----------|-----------|-----------|
| Rate of increase in pensionable pay | 3.8 | 3.7 | 3.7 |
| Rate of increase for present and future pensions | 2.8 | 2.7 | 2.7 |
| Rate used to discount scheme liabilities | 5.0 | 5.5 | 5.5 |
| Inflation | 2.8 | 2.7 | 2.7 |

NOTES TO THE FINANCIAL STATEMENTS

22 Pensions (continued)

The Company's share of the assets in the schemes, the present value of the liabilities in the schemes and the expected rate of return at each balance sheet date were:

| | 2006 | | 2005 | | 2004 | |
|---------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | Return % | Value £m | Return % | Value £m | Return % | Value £m |
| Equities | 7.7 | 167.3 | 7.8 | 144.7 | 7.7 | 129.9 |
| Property | 7.7 | 12.5 | 4.8 | 4.4 | - | - |
| Bonds | 4.7 | 77.0 | 4.8 | 35.9 | 4.7 | 32.1 |
| Other | 4.7 | 10.5 | 4.8 | 3.2 | 4.3 | 7.0 |
| Total market value of assets | | 267.3 | | 188.2 | | 169.0 |
| Present value of schemes' liabilities | | (301.7) | | (255.0) | | (233.9) |
| Deficit in schemes | | (34.4) | | (66.8) | | (64.9) |
| Related deferred tax asset | | 10.3 | | 20.1 | | 19.5 |
| Net pension liabilities | | (24.1) | | (46.7) | | (45.4) |

The following amounts have been recognised in the financial statements for the year ended 31 March 2006:

| | 2006 £m | 2005 £m |
|---|------------|------------|
| Operating profit | | |
| Current service cost | 5.8 | 5.7 |
| Past service cost | 1.0 | 0.6 |
| Total operating charge | 6.8 | 6.3 |
| Other finance income | | |
| Expected return on pension schemes' assets | 13.9 | 11.7 |
| Interest on pension schemes' liabilities | (14.0) | (12.9) |
| Net cost | (0.1) | (1.2) |
| Statement of total recognised gains and losses (STRGL) | | |
| Actual return less expected return on pension schemes' assets | 34.0 | 9.2 |
| Experience (losses) and gains arising on schemes' liabilities | (0.9) | (7.9) |
| Changes in assumptions underlying the present value of schemes' liabilities | (31.3) | - |
| Actuarial gain to be recognised in STRGL | 1.8 | 1.3 |

NOTES TO THE FINANCIAL STATEMENTS

22 Pensions (continued)

Movement in the Company share of the deficit in schemes during the year

| | 2006 £m | 2005 £m |
|---|---------------|---------------|
| Deficit at 1 April | (66.8) | (64.9) |
| Movement in year: | | |
| Current service cost | (5.8) | (5.7) |
| Company regular contributions | 4.7 | 4.3 |
| Prepayment of company regular contributions | 32.8 | - |
| Past service cost | (1.0) | (0.6) |
| Other finance income | (0.1) | (1.2) |
| Actuarial gain | 1.8 | 1.3 |
| Deficit at 31 March | <u>(34.4)</u> | <u>(66.8)</u> |

History of experience gains and losses

| | 2006 | 2005 |
|--|---------|--------|
| Difference between the expected and actual return in schemes' assets: | | |
| Amount (£m) | 34.0 | 9.2 |
| Percentage of schemes' assets | 12.7% | 5.4% |
| Experience gains and losses on schemes' liabilities: | | |
| Amount (£m) | (32.2) | (7.9) |
| Percentage of the present value of schemes' liabilities | (10.7)% | (3.4)% |
| Total amount recognised in statement of total recognised gains and losses: | | |
| Amount (£m) | 1.8 | 1.3 |
| Percentage of the present value of schemes' liabilities | 0.6% | 0.6% |

As a result of the prepayment of contributions made in 2005/06 no further Company regular contributions are expected to be paid to the schemes during the year ended 31 March 2007.

23 Called-up Share Capital

| | 2006 £m | 2005 £m |
|--|--------------|--------------|
| Authorised, 500,000,000 Ordinary shares of £1 each | <u>500.0</u> | <u>500.0</u> |
| Allotted, called-up and fully paid:- | | |
| 450,950,000 Ordinary shares of £1 each | <u>450.9</u> | <u>450.9</u> |

NOTES TO THE FINANCIAL STATEMENTS

24 Employee share schemes

The Company operates a number of share plans for the benefit of employees. Details of each plan are set out below:

i) Sharesave Scheme

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

Outstanding options to subscribe for Pennon Group Plc shares of £1.221/10 under the Sharesave Scheme 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 | | |
|--|--|---|------------|------------|
| | | 2006 | 2005 | |
| 7 July 1998 | 775p | 2001 - 2005 | - | 6 |
| 6 July 1999 | 825p | 2002 - 2006 | 5 | 5 |
| 5 July 2000 | 461p | 2003 - 2007 | 58 | 224 |
| 4 July 2001 | 489p | 2004 - 2008 | 55 | 58 |
| 9 July 2002 | 566p | 2005 - 2009 | 58 | 146 |
| 8 July 2003 | 530p | 2006 - 2010 | 327 | 345 |
| 6 July 2004 | 601p | 2007 - 2011 | 190 | 204 |
| 5 July 2005 | 810p | 2008 - 2012 | 156 | - |
| | | | 849 | 988 |

At 31 March 2006 there were 825 participants in the Sharesave Scheme (2005 875).

The number and weighted average exercise price of Sharesave options:

| | 2006 | | 2005 | |
|-------------|--|---|--|---|
| | 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 April 1 | 988 | 535 | 982 | 524 |
| Granted | 158 | 810 | 206 | 601 |
| Exercised | (252) | 503 | (128) | 514 |
| Expired | (45) | 545 | (72) | 558 |
| At March 31 | 849 | 594 | 988 | 535 |

The weighted average price at the date of exercise of Sharesave options during the year was 1,034p (2005 827p). The options outstanding at 31 March 2006 had a weighted average exercise price of 594p (2005 535p) and a weighted average remaining contractual life of 2.0 years (2005 2.1 years).

NOTES TO THE FINANCIAL STATEMENTS

24 Employee share schemes (continued)

i) Sharesave Scheme (continued)

The aggregate fair value of options granted during the year was £0.3m (2005 £0.3m), determined using the Black-Scholes valuation model. The significant inputs into the valuation model were:

| | 2006 | 2005 |
|---------------------------------|-----------|-----------|
| Weighted average share price | 779p | 654p |
| Weighted average exercise price | 623p | 523p |
| Expected volatility | 23.7% | 25.0% |
| Expected life | 3.9 years | 3.8 years |
| Risk-free rate | 4.5% | 4.6% |
| Expected dividend yield | 4.2% | 5.5% |

Expected volatility was determined by calculating the historical volatility of the Pennon Group Plc share price over the previous 2 years.

ii) Long Term Incentive Plan

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

The number and weighted average price of shares in the long-term incentive plan are:

| | 2006 | | 2005 | |
|------------------------|--|---|--|---|
| | Number of ordinary shares (thousands) | Weighted average price per share p | Number of ordinary shares (thousands) | Weighted average price per share p |
| At April 1 | 244 | 738 | 182 | 585 |
| Granted | 63 | 1,070 | 113 | 810 |
| Vested | (36) | 638 | (51) | 610 |
| Lapsed | (44) | 638 | - | - |
| Share consolidation | (21) | - | - | - |
| At March 31 | <u>206</u> | <u>861</u> | <u>244</u> | <u>738</u> |

The awards outstanding at 31 March 2006 had a weighted average price of 861p (2005 738p) and a weighted average remaining contractual life of 1.7 years (2005 1.8 years). The Pennon Group Plc share price at the date of the awards ranged from 585p to 1,070p.

The aggregate fair value of awards granted during the year was £0.4m (2005 £0.5m), determined using a Monte-Carlo simulation model. The significant inputs into the valuation model were:

| | 2006 | 2005 |
|------------------------------|-------|-------|
| Weighted average share price | 861p | 779p |
| Expected volatility | 23.6% | 25.0% |
| Risk-free rate | 4.6% | 4.8% |

Expected volatility was determined by calculating the historical volatility of the Pennon Group Plc share price over the previous 2 years.

NOTES TO THE FINANCIAL STATEMENTS

24 Employee share schemes (continued)

iii) Performance Related Bonus Plan

Awards under this plan to Directors and senior management involve the release of shares in Pennon Group Plc to participants, usually conditional upon continuous service with the Pennon Group for a period of three years from the date of the award.

The number and weighted average price of shares in the performance related bonus plan are:

| | 2006 | | 2005 | |
|------------------------|--|---|--|---|
| | Number of ordinary shares (thousands) | Weighted average price per share p | Number of ordinary shares (thousands) | Weighted average price per share P |
| At April 1 | 83 | 696 | 57 | 652 |
| Granted | 29 | 984 | 28 | 778 |
| Vested | (27) | 652 | - | - |
| Lapsed | (3) | 652 | (2) | 652 |
| Share consolidation | (7) | - | - | - |
| At March 31 | <u>75</u> | <u>806</u> | <u>83</u> | <u>696</u> |

The awards outstanding at 31 March 2006 had a weighted average price of 806p (2005 696p) and a weighted average remaining contractual life of 1.5 years (2005 2.2 years). The Pennon Group Plc share price at the date of the awards ranged from 652p to 984p.

The aggregate fair value of awards granted during the year was £0.3m (2005 £0.2m), determined from market value. No option pricing issues arise as dividends declared on the shares are receivable by the participants in the scheme.

25 Reserves

| | Profit and loss account £m | Hedging Reserve £m | Total £m |
|--|-------------------------------------|--------------------------|--------------|
| At 1 April 2005 as previously reported | 434.1 | - | 434.1 |
| Prior year adjustments (note 27) | (43.8) | - | (43.8) |
| | <u>390.3</u> | <u>-</u> | <u>390.3</u> |
| Adjustments on adoption of FRS 26 1 April 2005 | 9.7 | (0.9) | 8.8 |
| Profit on ordinary activities after taxation | 32.6 | - | 32.6 |
| Dividends paid (note 7) | (197.9) | - | (197.9) |
| Actuarial gain recognised in the pension scheme | 1.8 | - | 1.8 |
| Movement on deferred tax relating to pension liability | (9.7) | - | (9.7) |
| Adjustment for cost of Sharesave scheme | 0.3 | - | 0.3 |
| Deferred tax movement on share-based payments | 0.6 | - | 0.6 |
| Net movement on interest rate swaps | - | 0.4 | 0.4 |
| At 31 March 2006 | <u>227.7</u> | <u>(0.5)</u> | <u>227.2</u> |

The cumulative value of goodwill at 31 March 2006 resulting from acquisitions, which has been written off against reserves, is £1.4m (2005 £1.4m).

NOTES TO THE FINANCIAL STATEMENTS

26 Statement of Movements in Shareholders' Funds

| | 2006 £m | 2005 (restated) £m |
|---|----------------|--------------------------|
| Profit on ordinary activities after taxation | 32.6 | 57.7 |
| Dividends paid | (197.9) | (79.5) |
| Adjustments on adoption of FRS 26 1 April 2005 | 8.8 | - |
| Adjustment for cost of Sharesave scheme | 0.3 | 0.3 |
| Deferred tax movement on share-based payments | 0.6 | 0.3 |
| Other recognised gains and losses relating to the year | (7.5) | 1.9 |
| Net change in Shareholders' Funds | <u>(163.1)</u> | <u>(19.3)</u> |
| Shareholders' Funds as at 1 April (previously £885.0m before prior year adjustment of £43.8m) | <u>841.2</u> | <u>860.5</u> |
| Shareholders' Funds as at 31 March | <u>678.1</u> | <u>841.2</u> |

27 Prior Year Adjustment and Impact of New Accounting Standards

The prior year adjustment relates to the implementation of FRS 17 "Retirement Benefits" and FRS 20 "Share-based payment". The implementation of FRS 21 "Events after the balance sheet date", FRS 25 "Financial Instruments: Disclosure and Presentation" and FRS 26 "Financial Instruments: Measurement" does not affect comparatives and is only applied to the current period.

The adoption of FRS 17 has resulted in a decrease in operating costs by £1.6m (2005 £4.3m), an increase in other finance cost of £0.1m (2005 £1.2m), an increase in profit for the year by £1.5m (2005 £3.1m) and a decrease in total recognised gains and losses by £7.9m (2005 increase of £1.9m).

The adoption of FRS 20 has resulted in an increase in operating costs of £0.1m (2005 £0.2m), an increase in fixed asset investments of £0.4m (2005 £0.6m), a reduction in accruals of £0.3m (2005 £nil) and a reduction of the deferred tax provision by £0.6m (2005 £0.3m).

The adoption of FRS 25 has resulted in the repositioning of dividends from the profit and loss account to the profit and loss reserve.

The adoption of FRS 21 has increased reserves by £55.0m at 31 March 2006 because an interim dividend of £55.0m approved in February 2006 but not paid until May 2006 (see note 7) is not recognised as a liability at 31 March 2006.

FRS 26 has resulted in a net increase in reserves at 1 April 2005 of £8.8m comprising an increase of £14.8m from the release of a deferred interest rate swap less estimated corporation tax of £4.4m, a decrease of £0.9m from the recognition on the balance sheet of the fair value of other interest rate swaps and a decrease of £0.7m from discounting the value of trade debtors.

NOTES TO THE FINANCIAL STATEMENTS

27 Prior Year Adjustment and Impact of New Accounting Standards (continued)

Analysis of Prior Year Adjustment

| | FRS 17 £m | FRS 20 £m | Total £m |
|---|---------------|--------------|---------------|
| Adjustment to opening shareholders funds at 1 April 2004 | (49.8) | 0.5 | (49.3) |
| Adjustment to Profit and Loss Account for the year ended 31 March 2005 | 3.1 | (0.1) | 3.0 |
| Adjustment to Statement of Total Recognised Gains and Losses for year ended 31 March 2005 | 1.9 | - | 1.9 |
| Profit & Loss reserves movement | - | 0.6 | 0.6 |
| Adjustments to opening shareholders funds at 1 April 2005 | <u>(44.8)</u> | <u>1.0</u> | <u>(43.8)</u> |

The net prior year adjustment of £43.8m is disclosed on the face of the Statement of Total Recognised Gains and Losses.

28 Commitments and Contingent Liabilities

| | 2006 £m | 2005 £m |
|--|-------------|--------------|
| Capital commitments | | |
| Contracted but not provided | <u>64.8</u> | <u>44.2</u> |
| Commitments under operating leases | | |
| Rentals during the year following the balance sheet date | | |
| Land and buildings leases expiring:- | | |
| within one year | 0.1 | 0.1 |
| after five years | 1.2 | 1.2 |
| | <u>1.3</u> | <u>1.3</u> |
| Contingent Liabilities | | |
| Guarantee of borrowings of the parent undertaking | - | 150.0 |
| | <u>-</u> | <u>150.0</u> |

NOTES TO THE FINANCIAL STATEMENTS

29 Notes to the Cash Flow Statement

(a) Reconciliation of Operating Profit to Net Cash Inflow from Operating Activities

| | 2006 £m | 2005 (restated) £m |
|---|------------|--------------------------|
| Operating profit | 125.7 | 122.4 |
| Depreciation charge | 81.0 | 68.6 |
| Provision for impairment of fixed asset investments | 0.8 | 0.7 |
| Deferred income released to profits | (1.3) | (1.3) |
| Charge related to employee Sharesave scheme | 0.3 | 0.3 |
| Difference between pension charge & cash contributions | (31.4) | 2.1 |
| Increase / (decrease) in provisions for liabilities and charges | (0.5) | 0.6 |
| Increase in stocks | (0.3) | - |
| Decrease in debtors (amounts falling due within and over one year) | 5.4 | 7.0 |
| Increase / (decrease) in creditors (amounts falling due within and over one year) | 11.5 | (1.0) |
| Profit on disposal of tangible fixed assets | (1.4) | (1.2) |
| | <hr/> | <hr/> |
| Net cash inflow from operating activities | 189.8 | 198.2 |

Included within the net cash inflow from operating activities is a cash outflow of £14.5m (2005 £1.0m) relating to exceptional costs (note 4)

(b) Analysis of Cash Flows for Headings Netted in the Cash Flow Statement

| | 2006 £m | 2005 £m |
|--|------------|------------|
| (i) Returns on Investments and Servicing of Finance | | |
| Interest received | 21.3 | 13.9 |
| Interest paid | (83.6) | (35.3) |
| Interest element of finance lease rentals | (34.3) | (25.1) |
| | <hr/> | <hr/> |
| Net cash outflow for returns on investments and servicing of finance | (96.6) | (46.5) |

Included within the returns on investments and servicing of finance is a cash outflow of £42.3m (2005 £Nil) relating to exceptional costs (note 4)

| | 2006 £m | 2005 £m |
|---|------------|------------|
| (ii) Capital Expenditure and Financial Investment | | |
| Purchase of tangible fixed assets | (172.0) | (138.3) |
| Grants and contributions: Infrastructure assets | 2.1 | 2.8 |
| : Non-infrastructure assets | 0.5 | 0.1 |
| Receipts from disposal of tangible fixed assets | 2.4 | 1.6 |
| Purchase of fixed asset investments | (0.9) | (1.0) |
| | <hr/> | <hr/> |
| Net cash outflow for capital expenditure and financial investment | (167.9) | (134.8) |

NOTES TO THE FINANCIAL STATEMENTS

29 Notes to the Cash Flow Statement (Continued)

| | 2006 £m | 2005 £m |
|---|--------------|-------------|
| (iii) Management of Liquid Resources | | |
| Purchase of current asset investments | (139.1) | (304.6) |
| Sale of current asset investments | 355.3 | 323.6 |
| Net cash inflow from management of liquid resources | 216.2 | 19.0 |
| (iv) Financing | | |
| Decrease in debt due within one year (other than bank overdrafts) | (14.7) | (69.4) |
| Increase / (decrease) in debt due after more than one year | (45.0) | 15.0 |
| Finance lease drawdowns | 142.5 | 48.5 |
| Capital element of finance lease rental payments | (11.5) | (2.9) |
| Loans to parent undertaking | - | 61.6 |
| Net cash inflow from financing | 71.3 | 52.8 |

(c) Analysis of Net Debt

| | At 1 April 2005 £m | Cash flow £m | Non-cash movements £m | At 31 March 2006 £m |
|--|--------------------------|-----------------|-----------------------------|---------------------------|
| Cash at bank and in hand | 1.1 | (0.8) | - | 0.3 |
| Current asset investments:- | | | | |
| Overnight deposits | 20.4 | 31.3 | - | 51.7 |
| Bank overdrafts | (7.8) | (12.9) | - | (20.7) |
| | 13.7 | 17.6 | - | 31.3 |
| Debt due within one year (other than bank overdrafts) | (14.7) | 14.7 | (39.2) | (39.2) |
| Debt due after more than one year | (286.4) | (105.0) | 39.2 | (352.2) |
| Finance lease obligations | (809.6) | (131.0) | (4.7) | (945.3) |
| Amounts owed to parent undertaking | (150.0) | 150.0 | - | - |
| | (1,260.7) | (71.3) | (4.7) | (1,336.7) |
| Current asset investments:- other than overnight deposits | 217.2 | (216.2) | (1.0) | - |
| | (1,029.8) | (269.9) | (5.7) | (1,305.4) |

NOTES TO THE FINANCIAL STATEMENTS

29 Notes to the Cash Flow Statement (Continued)

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

(d) Reconciliation of Net Cash Flow to Movement in Net Debt

| | 2006 £m | 2005 £m |
|--|------------------|------------------|
| Increase in cash in year | 17.6 | 6.0 |
| Cash inflow from increase in debt and finance leasing | (71.3) | (52.8) |
| Cash inflow from decrease in liquid resources | <u>(216.2)</u> | <u>(19.0)</u> |
| Increase in net debt arising from cash flows | (269.9) | (65.8) |
| Non-cash movements:- | | |
| Increase in accrued finance charges on finance lease obligations | (5.7) | (8.6) |
| Other | <u>-</u> | <u>0.2</u> |
| Increase in net debt in the year | (275.6) | (74.2) |
| Net debt at 1 April | (1,029.8) | (955.6) |
| Net debt at 31 March | (1,305.4) | (1,029.8) |

30 Related Party Transactions

Under FRS8, transactions with other wholly owned subsidiaries of the Pennon Group Plc are not required to be set out herein since the Company is a wholly owned subsidiary within that group.

During the year the Company purchased services in the ordinary course of business from Echo South West Limited, a joint venture undertaking, at a cost of £9.1m (2005 £8.0m) and sold services to Echo South West Limited of £2.5m (2005 £2.5m). The Company was owed £1.3m by Echo South West Limited at 31 March 2006 (2005 £1.4m), as shown in note 14 and owed £0.2m (2005 £0.2m), as shown in note 16.

There were no related party transactions involving Directors during the year.

31 Events after the Balance Sheet Date

On 13 June 2006 the Company subscribed £12,500 for 100% of the ordinary share capital of South West Water Finance Plc, a company established to facilitate financing transactions.

On 22 June 2006 South West Water Finance Plc issued £100.0m guaranteed loan notes to Deutsche Bank. The loan notes are due 22 June 2050 with an option to terminate on 22 June 2010. The interest rate until 22 June 2010 is 4.13%. South West Water Limited provided the guarantee for the loan notes. On the same date South West Water Finance Plc lent £100.0m to South West Water Limited on similar terms to the loan notes agreement with Deutsche Bank.

32 Parent Company

The parent company, and ultimate controlling party, is Pennon Group Plc which is registered in England. Group financial statements are included in the Annual Report of Pennon Group Plc which is available from Peninsula House, Rydon Lane, Exeter, EX2 7HR.