

# **SOUTH WEST WATER LIMITED**

## **ANNUAL REPORT AND FINANCIAL STATEMENTS 2007**



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

# ANNUAL REPORT AND FINANCIAL STATEMENTS 2007

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## CHIEF EXECUTIVE'S REVIEW

South West Water continued to make excellent progress in delivering improvements to customer service and achieving regulatory performance targets

South West Water's operating profit rose by 10.6% (before exceptional costs in 2005/06) to £156.6m. The Company remains on track to deliver the demanding efficiency targets, set by Ofwat at the last price determination, over the 2005-2010 period.

Capital expenditure was £184m with over £70m being spent on quality schemes, principally mains water rehabilitation.

Further analysis of the financial results achieved in the year is presented within the Business Review on page 6.

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

'Clean Sweep' was a massive capital investment programme which dominated the Company's activities for the best part of two decades. As this nears completion, it is appropriate to look towards the future direction of the company and the many challenges it faces. This is particularly important as we begin planning for the next Periodic Review for the period 2010-2015. We want to strike the right balance for the future between investment to improve our services, financeability and, importantly, customer affordability. This is a particular challenge we are determined to meet. We must also meet the ongoing governmental and regulatory requirements whilst preparing for potential climate change impacts. The coming years should nevertheless see a shift away from capital delivery to achieve new standards driven by legislation, towards a more customer-focused agenda.

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

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

We achieved our best ever leakage performance. We have achieved or beaten our day leakage target in every year since targets were introduced by Ofwat in 1999/00.

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

'Clean Sweep's' success is evident from our achieving 100% compliance with mandatory bathing water standards for the first time (99% in 2005) at the 144 bathing waters in our area. Compliance with the even higher Guideline Standards has also improved to 92% from 89% the year before. The extent of this achievement can be measured against only 51% achievement 10 years ago. The population equivalent connected to sanitary compliant works was the highest ever at 99.6%.

## **CHIEF EXECUTIVE'S REVIEW (Continued)**

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

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

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

In preparing for the forthcoming periodic review of prices in 2009, a number of initiatives are underway to ensure that South West Water is prepared for the new challenges that lie ahead. The customer contact/billing contract will be re-tendered during 2007 and the company will build on the success of 'Service+'. The role of tariff structures in addressing the agenda of affordability and sustainability is also being reviewed. To meet the twin objectives of service excellence and operational efficiency, South West Water has launched a long-term project, 'Puros', to move the organisation towards a more centralised operational structure employing increased levels of automation and remote working. In the shorter term, a new 'rightsourcing' review is underway to determine the optimal combination of internal and external resource provision. It is expected that the cost of £3 million to £4 million of ongoing organisational restructuring will be provided for in 2007/08.

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

C Loughlin  
Chief Executive

## **DIRECTORS, REGISTERED OFFICE AND AUDITORS**

Chairman	K G Harvey
Chief Executive	C Loughlin
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 17 July 2007 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 2007
- 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

2 July 2007

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 2007

### 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

All numbers in this Annual Report are published for the first time in accordance with International Financial Reporting Standards (IFRS) with prior year figures restated. The principal differences between UK Generally Accepted Accounting Principles (UK GAAP) and IFRS are shown on pages 49 to 55 of the notes to the financial statements

South West Water turnover rose by £33.2m to £381.8m. Approved tariff increases amounted to £43.0m and 7,100 customer connections generated an additional £3.1m. However, 26,500 customers switching from unmeasured to metered charging (with each customer saving an estimated £300 on their annual bill) caused a reduction of £8.0m in turnover. Measured demand was down by an estimated 2.9%, reducing turnover by £5.1m.

Operating profit rose by 10.6% to £156.6m (compared to prior year before exceptional items). Operating efficiencies of £3.0m made a strong contribution to offsetting other additional costs, mainly arising from increased depreciation and operating costs from new and improved works (£9.6m), energy costs (£5.5m) and other inflation (£4.7m).

Net interest cost rose by £3.9m (7.2%) to £58.2m (compared to prior year before exceptional items). Net interest charges on pension scheme assets and liabilities were £3.2m lower than in the previous year with an increase of £4.3m on the expected return on pension scheme assets offset by an increase in the interest cost of retirement benefit obligations of £1.1m. The remaining increase of £7.1m reflects an increase in net borrowings during the year of £100.7m to £1,406.1m and the full year impact of the increase in gearing that arose from the financial restructuring undertaken in 2005/06.

The Company's taxation position results in a charge to mainstream corporation tax of £15.2m (2006 credit of £10.2m). A charge of £19.0m based on current year profits has been reduced by £1.0m resulting from a re-assessment of the corporation tax due for prior periods following submission of detailed computations and the surrender of £2.8m 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 (£8.0m in 2006/07, down from £17.6m in 2005/06). This is reflected in the level of the charge for deferred tax which is reduced from £22.2m last year to £11.1m this year.

#### Investment

High levels of investment in the Company's infrastructure were maintained in the year. Capital expenditure was £183.9m compared to £191.0m in 2005/06, with £70.8m spent on quality improvement schemes.

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

## **REPORT OF THE DIRECTORS (Continued)**

### **BUSINESS REVIEW (Continued)**

The Company's industry leading leakage record has been maintained with the Company meeting or bettering its 84ML a day target every year since annual targets were first introduced by Ofwat in 1999/2000

2006/07 was the tenth consecutive year without water restrictions. Park Pit, a former china clay pit near Bodmin, has also been purchased to improve water resources in Cornwall

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 2006 with every one of the 144 bathing waters in the Company's operating area meeting the Mandatory standard and compliance with the even higher Guideline standard now at its best ever level at 92%, up from 89% the year before

Service+, a major project to improve the service to customers in relation to the Company's daily operational activities and to reduce operating costs was launched in October 2006. The new Service Centre in Exeter utilises the latest mobile computing technology to give quicker, more accurate information to customers on service issues as well as better prioritising the work of field operations staff

### **Financing**

Net borrowings increased in the year by £100.7m to £1,406.1m. The ratio of debt to Regulatory Capital Value (RCV) was maintained at circa 62% at 31 March 2007 (2006 62%), within Ofwat's 'optimum range' of 55% - 65%

During the year, the Company's newly established subsidiary, South West Water Finance Plc, issued £100m loan notes (guaranteed by the Company) and then lent £100m to the Company on similar terms

The Company also sold and leased back under finance lease arrangements some £130m of plant, property and equipment

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 2007

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

During the year the remaining £55 0m of the £200 0m special dividend approved in 2005/06 in order to maximise the capital structure of the Company was paid, along with a dividend of £20 0m in respect of out-performance in 2005/06. No dividend was paid in respect of 2006/07 due to the reduction in distributable reserves resulting from the Company's adoption of IFRS and the requirement to provide in full for deferred taxation

As set out in note 36 to the financial statements, explaining the transition to IFRS, reserves at 31 March 2006 were reduced from the previously reported £227 2m to £3 4m because of the adoption of IFRS, the most significant difference being that IFRS does not permit the discounting of deferred tax balances. The significant on-going level of capital expenditure projected for the Company's operations means that the risk of this liability crystallising is expected to continue to be very low through the creation of further timing differences

### **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 RD09/07, which is available on the Ofwat website – [www.ofwat.gov.uk](http://www.ofwat.gov.uk). The RCV at 31 March 2007 is £2,265m compared to £2,091m at 31 March 2006, a growth of £174m (8.3%)

#### Operating Profit (before exceptional items)

## **REPORT OF THE DIRECTORS (Continued)**

### **BUSINESS REVIEW (Continued)**

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 £156.6m in 2006/07, up £15.0m (10.6%) on 2005/06.

#### 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 386 points out of a maximum of 438 in 2005/06 and maintained its position as sixth out of the 10 water and sewerage companies.

#### Drinking water compliance

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

#### **Employees**

The average number of employees during the year was 1,301 compared to 1,299 last year. Details of the related costs can be found in note 11 to the financial statements on page 29.

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' (IIP) 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.

The latest of an ongoing series of employee surveys was carried out during 2006 and IIP re-accreditation was also confirmed.

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.

## **REPORT OF THE DIRECTORS (Continued)**

### **BUSINESS REVIEW (Continued)**

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.

### **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.

The percentage of the population served by sanitary compliant waste water treatment works improved to 99.58% (99.41% in 2005).

The number of incidents classified by the EA as 'Category Two' (significant pollution incidents) in 2006/07 was 5. 4 were deemed non-compliant compared with 3 in 2005/06.

During the year, the Company was convicted on 7 occasions for environmental offences and fined a total of £30,000 compared with 2 convictions and £6,000 in fines in 2005/06. The Company has strategies in place to reduce incidents which lead to prosecution.

### **Payments to suppliers**

It is the Company's payment policy for the year ending 31 March 2008 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](http://www.payontime.co.uk). Trade creditors at 31 March 2007 represented 37 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.

## **REPORT OF THE DIRECTORS (Continued)**

### **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 4.

None of the Directors held any beneficial interest in the shares of the Company during the year.

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 retired on 31 July 2006. Chris Loughlin was appointed as a Director and Chief Executive with effect from 1 August 2006.

### **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 2007 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.

## **REPORT OF THE DIRECTORS (Continued)**

### **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 seventeenth annual general meeting will be held at Peninsula House, Rydon Lane, Exeter on 17 July 2007 at 10 00 am.

By Order of the Board



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

## **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 2007 which comprise the income statement, the balance sheet, the cash flow statement, the statement of recognised income and expense, 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 International Financial Reporting Standards (IFRSs) as adopted by the European Union 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.

In addition, we also report to you if, in our opinion, the Company has 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 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 IFRSs as adopted by the European Union, of the state of the Company's affairs at 31 March 2007 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



PricewaterhouseCoopers LLP  
Chartered Accountants  
and Registered Auditors  
Bristol

2 July 2007

## Income statement for the year ended 31 March 2007

	Notes	2007 £m	Before exceptional items 2006 £m	Exceptional items (note 9) 2006 £m	Total 2006 £m
<b>Revenue</b>	5	<b>381.8</b>	348 6	-	348 6
<b>Operating costs</b>	6				
Manpower costs		(34.0)	(32 1)	-	(32 1)
Raw materials and consumables used		(14.2)	(12 8)	-	(12 8)
Other operating expenses		(99.3)	(90 1)	(14 5)	(104 6)
Depreciation		(77.7)	(72 0)	-	(72 0)
<b>Operating profit</b>		<b>156.6</b>	141 6	(14 5)	127 1
Interest payable and similar charges	7	(79.8)	(80 7)	(50 2)	(130 9)
Interest receivable	7	21.6	26 4	7 9	34 3
<b>Profit before tax</b>		<b>98.4</b>	87 3	(56 8)	30 5
Tax on ordinary activities	8	(26.3)	(29 0)	17 0	(12 0)
<b>Profit for the year</b>		<b>72.1</b>	58 3	(39 8)	18 5
Profit attributable to equity shareholders		<b>72.1</b>	58 3	(39 8)	18 5

All operating activities are continuing activities

## Statement of recognised income and expense for the year ended 31 March 2007

	Notes	2007 £m	2006 £m
<b>Profit for the year</b>		<b>72.1</b>	18 5
Actuarial (losses)/gains on defined benefit schemes	24	(1.2)	1 5
Cash flow hedges net fair value gains		14.7	0 4
Tax on items taken directly to or transferred from equity		0.4	(0 5)
<b>Net gains not recognised directly in income statement</b>	29	<b>13.9</b>	1 4
<b>Total recognised income for the year</b>		<b>86.0</b>	19 9

The notes on pages 18 to 55 form part of these financial statements

## Balance sheet at 31 March 2007

	Notes	2007 £m	2006 £m
<b>Assets</b>			
<b>Non-current assets</b>			
Property, plant and equipment	13	2,243.5	2,143.1
Investment in subsidiary undertakings	15	3.3	3.3
Investment in joint venture	15	0.1	0.1
Trade and other receivables	14	0.7	1.5
		<u>2,247.6</u>	<u>2,148.0</u>
<b>Current assets</b>			
Inventories	16	4.0	4.0
Trade and other receivables	17	67.9	46.6
Derivative financial instruments	18	14.3	2.5
Cash and cash equivalents	19	118.8	52.0
		<u>205.0</u>	<u>105.1</u>
<b>Liabilities</b>			
<b>Current liabilities</b>			
Borrowings	22	(74.1)	(84.3)
Derivative financial instruments	18	-	(3.0)
Trade and other payables	20	(88.5)	(100.6)
Current tax liabilities	21	(15.0)	(3.0)
Provisions for liabilities and charges	26	-	(1.3)
		<u>(177.6)</u>	<u>(192.2)</u>
<b>Net current assets / (liabilities)</b>		<u>27.4</u>	<u>(87.1)</u>
<b>Non-current liabilities</b>			
Borrowings	22	(1,465.4)	(1,273.1)
Other non-current liabilities	23	(2.0)	(2.2)
Retirement benefit obligations	24	(34.5)	(35.0)
Deferred tax liabilities	25	(307.0)	(296.3)
		<u>(1,808.9)</u>	<u>(1,606.6)</u>
<b>Net assets</b>		<u>466.1</u>	<u>454.3</u>
<b>Shareholders' equity</b>			
Share capital	27	450.9	450.9
Retained earnings and other reserves	29	15.2	3.4
<b>Total shareholders' equity</b>		<u>466.1</u>	<u>454.3</u>

The notes on pages 18 to 55 form part of these financial statements

The financial statements on pages 15 to 55 were approved by the Board of Directors on 2 July 2007 and were signed on its behalf by



C Loughlin  
Chief Executive

## Cash flow statement for the year ended 31 March 2007

	Notes	2007 £m	2006 £m
<b>Cash flows from operating activities</b>			
Cash generated from operations	30	227.1	182.3
Interest paid*		(46.9)	(117.9)
Tax (paid) / received		(2.1)	2.7
Net cash generated from operating activities		<u>177.0</u>	<u>66.1</u>
<b>Cash flows from investing activities</b>			
Interest received*		3.1	20.3
Receipt of grants & contributions		3.0	2.6
Purchase of property, plant and equipment		(194.5)	(164.4)
Proceeds from sale of property, plant and equipment		3.1	2.4
Net cash used in investing activities		<u>(185.3)</u>	<u>(139.1)</u>
<b>Cash flows from financing activities</b>			
(Deposit) / release of restricted funds		(4.1)	177.1
Net proceeds from new borrowing		100.0	105.0
Repayment of borrowings		(39.2)	(14.7)
Finance lease drawdowns on sale of property, plant & equipment		130.8	142.5
Finance lease principal repayments		(20.1)	(11.5)
Dividends paid		(75.0)	(197.9)
Parent company loans		(14.6)	(150.0)
Net cash received from financing activities		<u>77.8</u>	<u>50.5</u>
<b>Net increase / (decrease) in cash and cash equivalents</b>		<b>69.5</b>	<b>(22.5)</b>
Cash and cash equivalents at beginning of the year	19	31.3	53.8
<b>Cash and cash equivalents at end of the year</b>	19	<u><b>100.8</b></u>	<u><b>31.3</b></u>

\* Interest paid and received included exceptional items in the prior year (note 9)

The notes on pages 18 to 55 form part of these financial statements

## NOTES TO THE FINANCIAL STATEMENTS

### 1 General information

South West Water Limited is a company incorporated in the United Kingdom under the Companies Act 1985. The address of the registered office is given on page 4. The nature of the Company's operations and its principal activities are set out in the Directors' report on page 6.

These financial statements were approved by the Board of Directors on 2 July 2007.

### 2 Significant accounting policies

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

#### (a) Basis of preparation

These are the first financial statements to have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. The disclosures required by IFRS 1 "First-time adoption of IFRS" concerning the transition from UK Generally Accepted Accounting Principles (UK GAAP) to IFRS are set out in note 36.

These financial statements have been prepared under the historical cost convention in accordance with International Financial Reporting Standards and International Financial Reporting Interpretation Committee (IFRIC) interpretations, as adopted by the European Union (EU), with those parts of the Companies Act 1985 applicable to companies reporting under IFRS. A summary of the main 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.

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

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

They have not been applied in these financial statements. The directors expect that the adoption of these standards and interpretations in future periods will have no material impact on the financial statements of the company. Additional disclosures on capital and financial instruments will be made when the relevant standards come into effect on or after 1 April 2007.

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

## NOTES TO THE FINANCIAL STATEMENTS

### 2 Significant accounting policies (Continued)

#### (b) First time adoption of IFRS

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

IFRS 1 requires an entity to comply with each IFRS effective at the reporting date for its first IFRS financial statements. As a general principle IFRS 1 requires the standards effective at the reporting date to be applied retrospectively. There are, however, a number of optional exemptions from full retrospective application. The Company has elected to take advantage of certain exemptions under IFRS 1 as follows

- To establish a deemed cost for the opening balance sheet carrying value of the water and wastewater infrastructure fixed assets by reference to the fair value of these assets at the date of transition to IFRS, 1 April 2005. All non-infrastructure assets have been carried forward using the depreciated historical cost UK GAAP balances as the deemed IFRS cost,
- Not to apply the requirements of IFRS 2 "Share-Based Payments" to options granted under the Company's share incentive schemes prior to 7 November 2002

#### (c) 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 of Pennon Group Plc which is registered within the European Economic Area and which itself produces consolidated financial statements. Accordingly consolidated financial statements have not been prepared and the financial information presented is for the Company as an individual undertaking. Group financial statements are included in the Annual Report of Pennon Group Plc which is available from Peninsula House, Rydon Lane, Exeter, EX2 7HR

#### (d) Revenue recognition

Revenue represents the fair value of consideration receivable, excluding value added tax, in the ordinary course of business for goods and services provided

Revenue is not recognised until the service has been provided to the customer

Income from water and wastewater charges includes an estimation of the amount of unbilled charges at the period end based upon a defined methodology reflecting historical consumption, estimated demand trends and current tariffs

## NOTES TO THE FINANCIAL STATEMENTS

### 2 Significant accounting policies (Continued)

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

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

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

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

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

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

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

Other assets are included at cost less accumulated depreciation.

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

Freehold buildings	30 – 60 years
Leasehold buildings	Over the period of the lease
Operational structures	40 – 80 years
Fixed plant	20 – 40 years
Vehicles, mobile plant and computers	3 – 10 years

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

The cost of assets includes directly attributable labour and overhead costs which are incremental to the Company.

Asset lives and residual values are reviewed annually.

#### (f) Grants and contributions

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

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

## NOTES TO THE FINANCIAL STATEMENTS

### 2 Significant accounting policies (Continued)

#### (g) Leased assets

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

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

#### (h) Inventories

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

#### (i) Cash and cash equivalents

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

#### (j) Derivatives and other financial instruments

The Company classifies its financial instruments in the following categories:

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

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

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

## NOTES TO THE FINANCIAL STATEMENTS

### 2 Significant accounting policies (Continued)

#### (j) 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 receivables*

Trade receivables do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts and the impact of discounting. 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 rate takes into account age of the debt, payment history and credit characteristics.

##### iv) *Trade payables*

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

#### (k) Taxation including deferred tax

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

#### (l) Dividend distributions

Dividend distributions are recognised as a liability in the Company's 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.

#### (m) Employee benefits

##### i) *Pension obligations*

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 Group's defined benefit pension schemes expected to arise from employee service in the period is charged to operating profit. The expected return on scheme assets and the increase during the period in the present value of scheme liabilities, arising from the passage of time, are included in other finance income or cost. Changes in past service costs arising from changes in benefits are recognised immediately in income.

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

## NOTES TO THE FINANCIAL STATEMENTS

### 2 Significant accounting policies (Continued)

#### (m) Employee benefits (Continued)

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

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

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

#### (n) Fair values

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

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

### 3 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. These instruments are analysed in more detail in note 22.

## NOTES TO THE FINANCIAL STATEMENTS

### 3 Financial risk management (Continued)

#### ii) Liquidity risk

The Company actively 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 22.

#### iii) Refinancing risk management

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

#### iv) Counterparty risk management

Counterparty risk arises from the investment of surplus funds and from the use of derivative instruments. The Board has agreed a policy for managing such risk, which is controlled through credit limits, counterparty approvals, and rigorous monitoring procedures. The Company has no other significant concentration of credit risk. 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 a credit rating threshold approved by the Pennon Group Board.

### 4 Critical accounting judgements

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

Areas which management believes require the most critical accounting judgements are

#### *Exceptional items*

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

#### *Retirement benefit obligations*

The Company's employees are eligible to participate in funded defined benefit schemes, operated by the parent company. Actuarial valuations of the schemes are carried out as determined by the trustees at intervals of not more than three years.

The pension cost under IAS 19 is assessed in accordance with the advice of an independent qualified actuary based on the latest actuarial valuation and assumptions determined by the actuary. The assumptions are based on information supplied to the actuary by the Company, supplemented by discussions between the actuary and management. The assumptions are disclosed in note 24 of the financial statements.

## NOTES TO THE FINANCIAL STATEMENTS

### 4 Critical accounting judgements (Continued)

Areas which management believes require the most critical accounting estimation are as follows

#### *Carrying value of long-life assets*

The Company's accounting policy for property, plant and equipment is detailed in note 2 of the financial statements. The carrying value of property, plant and equipment as at 31 March 2007 was £2,244m. In the year ended 31 March 2007 additions to property, plant and equipment totalled £184m and the depreciation charge was £79m. Estimated useful economic lives of tangible fixed assets are based on management's judgement and experience. When management identifies that actual useful lives differ materially from the estimates used to calculate depreciation, that charge is adjusted prospectively. Due to the significance of capital investment to the Company, variations between actual and estimated useful lives could impact operating results both positively and negatively. Historically, only minor changes to estimated useful lives have been required.

#### *Revenue recognition*

The Company recognises revenue generally at the time of delivery. Payments received in advance of revenue recognition are recorded as deferred revenue.

The Company raises bills and recognises revenue in accordance with its entitlement to receive revenue in line with the limits established by the Periodic Review price setting process. For water and wastewater customers with water meters, income recognised is dependent upon the volume supplied including an estimate of the sales value of units supplied between the date of the last meter reading and the year end. Estimated usage is based on historic data, judgement and assumptions, actual results could differ from these estimates which would result in operating revenue being adjusted in the period that the revision to the estimates is determined.

#### *Provision for doubtful debts*

At each balance sheet date, the Company evaluates the collectability of trade receivables and records provisions for impairment of receivables based on experience including, for example, comparisons of the relative age of accounts and consideration of actual write-off history. The actual level of debt collected may differ from the estimated levels of recovery, which could impact operating results positively or negatively. As at 31 March 2007 current trade receivables were £47m.

### 5 Segmental reporting

The Directors believe that the whole of the Company's activities constitute a single class of business.

The Company's turnover is wholly generated from within the United Kingdom.

## NOTES TO THE FINANCIAL STATEMENTS

### 6 Operating costs

	2007 £m	2006 £m
Manpower costs (note 11)	<u>34.0</u>	<u>32.1</u>
Raw materials and consumables	<u>14.2</u>	<u>12.8</u>
<b>Other operating expenses include</b>		
Profit on disposal of property, plant and equipment	(2.5)	(1.4)
Operating lease rentals payable		
- Plant and machinery	0.7	0.8
- Property	1.4	1.3
Research and development expenditure	0.1	0.1
Trade receivables impairment	<u>5.4</u>	<u>5.5</u>
Depreciation of property, plant and equipment		
- Owned assets	57.5	50.3
- Under finance leases	<u>20.2</u>	<u>21.7</u>
	<u>77.7</u>	<u>72.0</u>

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

	2007 £000	2006 £000
Audit of the Company's accounts	120	123
Audit-related regulatory reporting	45	-
Other services	<u>3</u>	<u>4</u>
	<u>168</u>	<u>127</u>

### 7 Net finance costs

	2007 £m	2006 £m
Interest payable		
Intercompany interest	(3.2)	(12.8)
Bank borrowings and overdrafts	(19.8)	(16.7)
Interest element of finance lease rentals	(41.5)	(38.7)
Other finance costs	(0.2)	1.5
Interest cost on retirement benefit obligations	<u>(15.1)</u>	<u>(14.0)</u>
<b>Interest payable and similar charges</b>	<u>(79.8)</u>	<u>(80.7)</u>
Interest receivable	2.7	11.2
Intercompany interest	0.7	1.3
Expected return on pension scheme assets	<u>18.2</u>	<u>13.9</u>
<b>Interest receivable and similar charges</b>	<u>21.6</u>	<u>26.4</u>
<b>Net finance costs</b>	<u>(58.2)</u>	<u>(54.3)</u>

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

## NOTES TO THE FINANCIAL STATEMENTS

8 <b>Taxation</b>	<b>2007</b> <b>£m</b>	2006 <b>£m</b>
<b>Analysis of charge in year</b>		
Current tax	15.2	(10.2)
Deferred tax (note 25)	11.1	22.2
	<u>26.3</u>	<u>12.0</u>

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

	<b>2007</b> <b>£m</b>	2006 <b>£m</b>
Profit before tax	<u>98.4</u>	<u>30.5</u>
Profit before tax multiplied by standard rate of corporation tax in the UK of 30% (2005 30%)	29.5	9.2
Effects of		
Expenses not deductible for tax purposes	0.2	1.1
Sale of assets and finance leasing	(3.8)	(0.5)
Other	(0.1)	3.0
Adjustments to tax charge in respect of prior year	0.5	(0.8)
Tax charge for year	<u>26.3</u>	<u>12.0</u>

The average applicable tax rate for the year was 27% (2006 39%).

In addition to the amount charged to the income statement, a deferred tax credit relating to actuarial losses on defined benefit schemes of £0.4m (2006 £0.5m charge on actuarial gains) has been credited directly to equity. Also, in 2006 a deferred tax credit relating to share-based payment of £0.6m was credited directly to equity.

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

At 31 March 2007 the above changes were not substantively enacted. If the change in corporation tax rate is fully enacted, the deferred tax liability would reduce by £20.5m. The provisions to abolish industrial building allowances are expected to be contained in the Finance Bill 2008. If fully enacted, the total impact on the deferred tax liability of this change is expected to be an increase of £32.5m. The combined impact would therefore be to increase the deferred tax liability by £12.0m.

## NOTES TO THE FINANCIAL STATEMENTS

9	<b>Exceptional items</b>	<b>2007 £m</b>	<b>2006 £m</b>
	The exceptional items are		
	Customer payment following financial restructuring	-	(14.5)
	<b>Operating profit</b>	<u>-</u>	<u>(14.5)</u>
	<b>Net finance costs</b>		
	Cost of redeeming loan from parent undertaking	-	(50.2)
	Consent fee on assignment of finance lease	-	7.9
		<u>-</u>	<u>(42.3)</u>
	<b>Profit before tax</b>	-	(56.8)
	Tax arising on exceptional items	-	17.0
	<b>Profit after tax</b>	<u>-</u>	<u>(39.8)</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

10	<b>Dividends</b>	<b>2007 £m</b>	<b>2006 £m</b>
	Amounts recognised as distributions to equity holders in the year		
	Final dividend of 4.44p in respect of 2005/06 (2006 11.73p) per ordinary share paid 23 November 2006	<b>20.0</b>	52.9
	Special interim dividend	<b>55.0</b>	145.0
		<u><b>75.0</b></u>	<u>197.9</u>

On 23 February 2006, in order to optimise the capital structure of the Company, the Directors approved payment of a 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.

## NOTES TO THE FINANCIAL STATEMENTS

### 11 Employment costs

The average number of persons (including Directors) employed by the Company was 1,301 (2006 1,299)

	2007	2006
	£m	£m
Employment costs comprise		
Wages and salaries	32.2	33.2
Social security costs	2.3	2.6
Pension costs	8.3	6.1
Share-based payments	1.1	0.8
<b>Total employment costs</b>	<b><u>43.9</u></b>	<b><u>42.7</u></b>
Charged as follows		
Manpower costs	34.0	32.1
Capital schemes	9.9	10.0
Restructuring provision	-	0.6
<b>Total employment costs</b>	<b><u>43.9</u></b>	<b><u>42.7</u></b>

Details of Directors emoluments are set out in note 12. There are no personnel other than Directors, who as key management exercise authority and responsibility for planning, directing and controlling the activities of the Group.

### 12 Directors' emoluments

	2007	2006
	£000	£000
Total emoluments of the Directors of the Company		
Salary	508	449
Performance related	132	114
Other emoluments	128	43
<b>Total emoluments</b>	<b><u>768</u></b>	<b><u>606</u></b>

The performance related payment represents the cash element. In addition Directors receive a conditional award of shares for a matching amount which is subject to a future service criterion.

Other emoluments include car benefit and health care, and, in respect of the highest paid Director, a cash payment of 30% of his annual basic salary in lieu of any pension provision by the Company and relocation costs and expenses consequent on his appointment.

The emoluments of the highest paid Director were £261,000 (2006 £232,000).

At 31 March 2007 retirement benefits were accruing to 3 Directors (2006 4 Directors) under defined benefit pension schemes operated by the parent company.

The highest paid Director did not participate in a company pension scheme.

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

## NOTES TO THE FINANCIAL STATEMENTS

### 13 Property, plant & equipment

	Land and buildings £m	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant, vehicles and computers £m	Construction in progress £m	Total £m
<b>Cost :</b>						
At 1 April 2005	12.7	1,017.5	555.4	830.6	70.0	2,486.2
Additions	0.8	56.4	3.5	33.7	96.6	191.0
Grants & contributions	-	(1.1)	-	-	-	(1.1)
Disposals	(0.8)	-	(5.8)	(62.0)	-	(68.6)
Transfers/ reclassifications	1.2	23.6	12.3	29.7	(66.8)	-
<b>At 31 March 2006</b>	<b>13.9</b>	<b>1,096.4</b>	<b>565.4</b>	<b>832.0</b>	<b>99.8</b>	<b>2,607.5</b>
Additions	0.8	60.6	2.2	42.7	77.6	183.9
Grants & contributions	-	(3.6)	-	-	-	(3.6)
Disposals	(0.5)	(0.7)	-	(2.5)	-	(3.7)
Transfers/ reclassifications	1.4	32.5	11.4	39.8	(85.1)	-
<b>At 31 March 2007</b>	<b>15.6</b>	<b>1,185.2</b>	<b>579.0</b>	<b>912.0</b>	<b>92.3</b>	<b>2,784.1</b>
<b>Depreciation :</b>						
At 1 April 2005	3.9	-	119.0	335.9	-	458.8
Charge for year	0.2	13.2	10.5	49.4	-	73.3
Disposals	(0.3)	-	(5.8)	(61.6)	-	(67.7)
<b>At 31 March 2006</b>	<b>3.8</b>	<b>13.2</b>	<b>123.7</b>	<b>323.7</b>		<b>464.4</b>
Charge for year	0.2	15.2	10.9	53.0	-	79.3
Disposals	(0.3)	(0.7)	-	(2.1)	-	(3.1)
<b>At 31 March 2007</b>	<b>3.7</b>	<b>27.7</b>	<b>134.6</b>	<b>374.6</b>		<b>540.6</b>
<b>Net book value</b>						
At 31 March 2006	10.1	1,083.2	441.7	508.3	99.8	2,143.1
<b>At 31 March 2007</b>	<b>11.9</b>	<b>1,157.5</b>	<b>444.4</b>	<b>537.4</b>	<b>92.3</b>	<b>2,243.5</b>

Out of the total depreciation charge for the Company of £79.3m (2006 £73.3m), the sum of £1.6m (2006 £1.3m) has been charged to capital projects, and £77.7m (2006 £72.0m) against profits

## NOTES TO THE FINANCIAL STATEMENTS

### 13 Property, plant & equipment (Continued) Assets held under finance leases included above

	Land & buildings £m	Infrastructure assets £m	Operational properties £m	Fixed & mobile plant, vehicles & computers £m	Construction in progress £m	Total £m
Cost						
At 31 March 2006	-	181.1	380.2	234.5	84.1	879.9
<b>At 31 March 2007</b>	<b>-</b>	<b>271.3</b>	<b>387.3</b>	<b>285.5</b>	<b>63.7</b>	<b>1,007.8</b>
Depreciation						
At 31 March 2006	-	3.5	54.6	114.2	-	172.3
<b>At 31 March 2007</b>	<b>-</b>	<b>6.4</b>	<b>59.9</b>	<b>124.3</b>	<b>-</b>	<b>190.6</b>
Net book amount						
At 31 March 2006	-	177.7	325.6	120.3	84.1	707.6
<b>At 31 March 2007</b>	<b>-</b>	<b>264.8</b>	<b>327.4</b>	<b>161.2</b>	<b>63.7</b>	<b>817.1</b>

### 14 Trade and other receivables non-current

	2007 £m	2006 £m
Amounts owed by subsidiary company	0.7	1.4
Amounts owed by joint venture	-	0.1
	<u>0.7</u>	<u>1.5</u>

### 15 Investments

	2007 £m	2006 £m
Subsidiary undertakings	<u>3.3</u>	<u>3.3</u>
Joint venture	<u>0.1</u>	<u>0.1</u>

The Company has three wholly-owned subsidiaries, Peninsula Properties (Exeter) Limited, Peninsula Leasing Limited and South West Water Finance Plc. The shares in South West Water Finance Plc were purchased for £12,500 in June 2006. All companies are incorporated, registered and have their operation in England.

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 is 50%.

Consolidated financial statements have not been prepared, as explained in note 2 (c).

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.

## NOTES TO THE FINANCIAL STATEMENTS

16	<b>Inventories</b>	<b>2007</b> <b>£m</b>	<b>2006</b> <b>£m</b>
	Raw materials and consumables	<u>4.0</u>	<u>4.0</u>
17	<b>Trade and other receivables – current</b>	<b>2007</b> <b>£m</b>	<b>2006</b> <b>£m</b>
	Trade receivables	46.6	38.2
	Less provision for impairment of receivables	<u>(30.9)</u>	<u>(24.4)</u>
	Net trade receivables	15.7	13.8
	Amounts owed by subsidiary companies	1.0	0.1
	Amounts owed by fellow subsidiary companies	6.1	5.4
	Amounts owed by joint venture	0.9	1.1
	Amount owed by parent undertaking	14.7	1.2
	Other receivables	1.7	3.6
	Other prepayments and accrued income	27.8	21.4
		<u>67.9</u>	<u>46.6</u>

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

18	<b>Derivative financial instruments</b>	<b>2007</b> <b>£m</b>	<b>2006</b> <b>£m</b>
	Interest rate swaps – cash flow hedges		
	Assets	<u>14.3</u>	<u>2.5</u>
	Liabilities	<u>-</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 2007 66% of net borrowings was at fixed rate (2006 60%)

At 31 March 2007 interest rate swaps to hedge financial liabilities with a notional principal value of £584.0m existed, with a weighted average maturity of 3.1 years (2006 £626.0m, with 3.5 years) to swap from floating to fixed rate. The weighted average interest rate of the swaps was 4.9% (2006 4.9%)

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

## NOTES TO THE FINANCIAL STATEMENTS

19	<b>Cash and cash equivalents</b>	<b>2007</b>	<b>2006</b>
		<b>£m</b>	<b>£m</b>
	Cash at bank and in hand	0.3	0.3
	Overnight deposits	54.2	51.7
	Other short-term deposits	60.2	-
	Other deposits	4.1	-
		<u>118.8</u>	<u>52.0</u>

The effective interest rate on short-term deposits was 5.3% (2006 4.7%) and these deposits have an average maturity of 3 days

Other deposits include £4.1m (2006 nil) of restricted funds to settle long-term liabilities (note 22)

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

	<b>2007</b>	<b>2006</b>
	<b>£m</b>	<b>£m</b>
Cash and cash equivalents as above	118.8	52.0
Overdrafts (note 22)	(13.9)	(20.7)
	<u>104.9</u>	<u>31.3</u>
Less deposits with a maturity of three months or more	(4.1)	-
	<u>100.8</u>	<u>31.3</u>

20	<b>Trade and other payables – current</b>	<b>2007</b>	<b>2006</b>
		<b>£m</b>	<b>£m</b>
	Trade payables	57.7	69.2
	Amounts owed to parent undertaking	0.1	2.3
	Amounts owed to subsidiary companies	1.6	0.1
	Amounts owed to fellow subsidiaries	0.2	0.3
	Amounts owed to joint venture	0.2	0.2
	Other tax and social security	8.3	1.0
	Other payables	3.4	5.5
	Accruals	17.0	21.8
	Deferred income	-	0.2
		<u>88.5</u>	<u>100.6</u>

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

21	<b>Current tax liabilities</b>	<b>2007</b>	<b>2006</b>
		<b>£m</b>	<b>£m</b>
	Corporation tax	<u>15.0</u>	<u>3.0</u>

## NOTES TO THE FINANCIAL STATEMENTS

22	<b>Borrowings</b>	<b>2007</b>	<b>2006</b>
		<b>£m</b>	<b>£m</b>
	<b>Current</b>		
	Bank overdrafts	13.9	20.7
	Short-term loans	-	35.0
	European Investment Bank	16.3	4.2
		<u>30.2</u>	<u>59.9</u>
	Obligations under finance leases	43.9	24.4
		<u>74.1</u>	<u>84.3</u>
	<b>Non-current</b>		
	European Investment Bank	215.9	232.2
	Bank loans	120.0	120.0
	Loan from subsidiary company	100.0	-
		<u>435.9</u>	<u>352.2</u>
	Obligations under finance leases	1,029.5	920.9
		<u>1,465.4</u>	<u>1,273.1</u>
	<b>Total borrowings</b>	<u>1,539.5</u>	<u>1,357.4</u>

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

The fair value of the non-current borrowings were

	2007		2006	
	Book value	Fair value	Book value	Fair Value
	£m	£m	£m	£m
European Investment Bank	215.9	210.9	232.2	226.9
Bank loans	120.0	120.0	120.0	120.0
Loan from subsidiary company	100.0	99.6	-	-
	<u>435.9</u>	<u>430.5</u>	<u>352.2</u>	<u>346.9</u>
Obligations under finance leases	1,029.5	917.9	920.9	878.7
	<u>1,465.4</u>	<u>1,348.4</u>	<u>1,273.1</u>	<u>1,225.6</u>

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

The exposure to interest rate changes (before the impact of swaps – note 18) and the repricing dates at the balance sheet date is

	<b>2007</b>	<b>2006</b>
	<b>£m</b>	<b>£m</b>
6 months or less	871.9	694.1
6 – 12 months	448.5	420.5
1 – 5 years	219.1	242.8
	<u>1,539.5</u>	<u>1,357.4</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 22 Borrowings (Continued)

The maturity of non-current borrowings was

	2007	2006
	£m	£m
Between 1 and 2 years	90.9	44.2
Between 2 and 5 years	310.3	227.1
Over 5 years	1,064.2	1,001.8
	<u>1,465.4</u>	<u>1,273.1</u>

The effective interest rates (before the impact of swaps – note 18) at the balance sheet date were

	2007	2006
	%	%
Bank overdrafts	6.3	5.5
Short-term loans	n/a	5.5
European Investment Bank	5.6	4.7
Bank loans	5.9	4.9
Finance leases	4.4	3.8
Loan from subsidiary company	4.1	n/a

Finance lease liabilities – minimum lease payments

	2007	2006
	£m	£m
Within one year	59.1	34.7
In the second to fifth years inclusive	266.0	212.8
After five years	1,866.6	1,379.1
	<u>2,191.7</u>	<u>1,626.6</u>
Less future finance charges	<u>(1,118.4)</u>	<u>(681.3)</u>
	<u>1,073.4</u>	<u>945.3</u>

Included above are accrued finance charges arising on obligations under finance leases totalling £126.4m (2006 £108.2m), of which £36.5m (2006 £23.9m) is repayable within one year

Included above is £27.8m (2006 £1.0m) due to Peninsula Leasing Limited, a subsidiary company, under finance lease agreements of which £6.4m (2006 £0.5m) is repayable within one year

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

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

## NOTES TO THE FINANCIAL STATEMENTS

### 22 Borrowings (Continued)

The Company has undrawn committed borrowing facilities

	2007 £m	2006 £m
Floating rate		
Expiring within one year	120.0	50.0
Expiring after one year	45.0	110.0
	<u>165.0</u>	<u>160.0</u>

In addition, the Company has short-term uncommitted bank facilities of £90.0m (2006 £90.0m)

### 23 Other non-current liabilities

	2007 £m	2006 £m
Other creditors	<u>2.0</u>	<u>2.2</u>

### 24 Retirement benefit obligations

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

The principal actuarial assumptions at the balance sheet date were

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

More detailed information for the Pennon Group pension funds on assumptions regarding future mortality experience and the sensitivities regarding the principal assumptions used to measure the schemes' liabilities are given in the financial statements of Pennon Group Plc.

## NOTES TO THE FINANCIAL STATEMENTS

### 24 Retirement benefit obligations (Continued)

The amounts recognised in the income statement were

	2007 £m	2006 £m
Current service cost	(8.7)	(5.8)
Past service cost	(0.8)	(1.0)
Total included within operating costs	<u>(9.5)</u>	<u>(6.8)</u>
Expected return on pension schemes' assets	18.2	13.9
Interest cost on retirement benefit obligations	(15.1)	(14.0)
Total included within net finance costs	<u>3.1</u>	<u>(0.1)</u>
Total charge	<u>(6.4)</u>	<u>(6.9)</u>

The actual return on schemes' assets was £21.4m (2006 £47.3m)

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

	2007 £m	2006 £m
Actuarial (losses)/gains recognised in the year (net of tax)	<u>(1.2)</u>	<u>1.5</u>

The experience loss in 2007 of £1.2m includes an increase in liabilities of £13.4m arising from the use of an updated longevity assumption for pensioners

The amounts recognised in the balance sheet were

	2007 £m	2006 £m
Fair value of scheme's assets	285.5	266.7
Present value of defined benefit obligations	(320.0)	(301.7)
Net liability recognised in the balance sheet	<u>(34.5)</u>	<u>(35.0)</u>

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

	Expected return %	2007 Value £m	Fund %	Expected Return %	2006 Value £m	Fund %
Equities	8.0	160.4	56	7.7	166.7	62
Property / currency	7.8	30.1	11	7.7	12.5	5
Bonds	4.7	94.6	33	4.7	77.0	29
Other	5.0	0.4	-	4.7	10.5	4
		<u>285.5</u>	<u>100</u>		<u>266.7</u>	<u>100</u>

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

## NOTES TO THE FINANCIAL STATEMENTS

### 24 Retirement benefit obligations (Continued)

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

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

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

The Company provides retirement benefits to some of its former and approximately 97% of current employees through defined benefit schemes. The level of retirement benefit is principally based on final annual salary earned in employment.

Movements in the balance sheet liability were

	2007 £m	2006 £m
At 1 April 2006	(35.0)	(67.1)
Income statement	(6.4)	(6.9)
Statement of recognised income and expenditure	(1.2)	1.5
Regular contributions	1.7	4.7
Prepayment of contributions	6.4	32.8
At 31 March 2007	<u>(34.5)</u>	<u>(35.0)</u>

Movements in the fair value of scheme's assets were

	2007 £m	2006 £m
At 1 April 2006	266.7	187.9
Expected return on schemes' assets	18.2	13.9
Actuarial gains	3.2	33.7
Members' contributions	0.2	1.6
Benefits paid	(10.9)	(7.9)
Company regular contributions	1.7	4.7
Prepayment of Company regular contributions	6.4	32.8
At 31 March 2007	<u>285.5</u>	<u>266.7</u>

Movements in the present value of defined benefit obligations were

	2007 £m	2006 £m
At 1 April 2006	(301.7)	(255.0)
Service costs	(9.5)	(6.8)
Interest cost	(15.1)	(14.0)
Members' contributions	(0.2)	(1.6)
Benefits paid	10.9	7.9
Actuarial gains and losses	(4.4)	(32.2)
At 31 March 2007	<u>(320.0)</u>	<u>(301.7)</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 24 Retirement benefit obligations (Continued)

The Company adopted IAS 19 from 1 April 2005 and the following historical data has been presented from that date. The historical data will be built up to a rolling five-year record over the next three years.

	2007	2006
	£m	£m
Fair value of scheme's assets	285.5	266.7
Present value of defined benefit obligations	<u>(320.0)</u>	<u>(301.7)</u>
Net liability recognised	<u>(34.5)</u>	<u>(35.0)</u>
Experience gains on scheme's assets		
Amount (£m)	3.2	33.7
Percentage of scheme's assets	1.1%	12.6%
Experience losses on defined benefit obligations		
Amount (£m)	(4.4)	(32.2)
Percentage of defined benefit obligations	(1.4)%	(10.7)%

The most recently completed triennial actuarial valuation of the Pennon Group's defined benefit schemes was carried out as at 1 April 2004, following which the Company's current service cost increased from 11.5% of pensionable earnings in 2004/05 to 21.7% in 2006/07. On 1 April 2006 the existing section was closed to new entrants (replaced by a new section with reduced benefits) and contribution rates for most employees were increased from 5% to 7%. In August 2005 a prepayment of Company regular pension contributions to March 2010 of £32.8m was made. A further £6.4m prepayment was made in September 2006. As a result of these prepayments no further Company regular contributions are expected to be paid to the schemes during the year ended 31 March 2008.

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

More detailed information for the Pennon Group pension funds on the period over which the benefits payable by the pension scheme are expected to be paid are given in the financial statements of Pennon Group Plc.

### 25 Deferred tax liabilities

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

The movement on the deferred tax account were

	2007	2006
	£m	£m
At 1 April	296.3	274.2
Charged to the income statement	11.1	22.2
Credited to equity	(0.4)	(0.1)
At 31 March	<u>307.0</u>	<u>296.3</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 25 Deferred tax liabilities (continued)

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

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

#### Deferred tax liabilities

	Accelerated tax depreciation		Total £m
	Owned assets £m	Leased assets £m	
At 1 April 2005	297.5	4.3	301.8
Charged to the income statement	16.8	0.8	17.6
At 31 March 2006	314.3	5.1	319.4
Charged to the income statement	3.1	4.9	8.0
<b>At 31 March 2007</b>	<b>317.4</b>	<b>10.0</b>	<b>327.4</b>

#### Deferred tax assets

	Provisions £m	Retirement benefit	Other £m	Total £m
		obligations £m		
At 1 April 2005	(4.9)	(20.0)	(2.7)	(27.6)
Charged/(credited) to the income statement	0.5	9.2	(5.1)	4.6
Charged /(credited) to equity	-	0.5	(0.6)	(0.1)
At 31 March 2006	(4.4)	(10.3)	(8.4)	(23.1)
Charged to the income statement	0.6	0.4	2.1	3.1
Credited to equity	-	(0.4)	-	(0.4)
<b>At 31 March 2007</b>	<b>(3.8)</b>	<b>(10.3)</b>	<b>(6.3)</b>	<b>(20.4)</b>

Net deferred tax liability

At 31 March 2006	296.3
<b>At 31 March 2007</b>	<b>307.0</b>

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

	2007 £m	2006 £m
Actuarial gains/(losses) on defined benefit schemes	0.4	(0.5)
Share-based payments (note 29)	-	0.6
	<b>0.4</b>	<b>0.1</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 26 Provisions for liabilities and charges

Restructuring	<b>2007</b>
	<b>£m</b>
At 1 April 2006	<b>1.3</b>
Credited to the income statement	<b>(0.2)</b>
Utilised during year	<b>(1.1)</b>
<b>At 31 March 2007</b>	<b>-</b>

The analysis of provisions between current and non-current is

	<b>2007</b>	<b>2006</b>
	<b>£m</b>	<b>£m</b>
Current	-	1.3
Non-current	-	-
	<u>-</u>	<u>1.3</u>

### 27 Called-up share capital

	<b>2007</b>	<b>2006</b>
	<b>£m</b>	<b>£m</b>
<b>Authorised</b>		
500,000,000 Ordinary shares of £1 each	<u>500.0</u>	<u>500.0</u>
<b>Allotted, called-up and fully paid</b>		
450,950,000 Ordinary shares of £1 each	<u>450.9</u>	<u>450.9</u>

### 28 Employee share schemes

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

#### i) Sharesave Scheme

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

## NOTES TO THE FINANCIAL STATEMENTS

### 28 Employee share schemes (continued)

Outstanding options to subscribe for Pennon Group Plc shares of 40 7p each 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	
		2007	2006
6 July 1999 275p	2002 – 2006	1	15
5 July 2000 154p	2003 – 2007	171	174
4 July 2001 163p	2004 – 2008	32	165
9 July 2002 189p	2005 – 2009	171	174
8 July 2003 177p	2006 – 2010	268	981
6 July 2004 200p	2007 – 2011	538	570
5 July 2005 270p	2008 – 2012	440	468
4 July 2006 358p	2009 – 2013	431	-
		<b>2052</b>	<b>2,547</b>

At 31 March 2007 there were 721 participants in the Sharesave Scheme (2006 749)

The number and weighted average exercise price of Sharesave options are

	2007		2006	
	Number of ordinary shares (thousands)	Weighted average exercise price per share p	Number of ordinary shares (thousands)	Weighted average exercise price per share p
At 1 April	2547	198	2,964	178
Granted	444	358	474	270
Exercised	(871)	176	(756)	168
Expired	(68)	235	(135)	182
At 31 March	<b>2052</b>	<b>240</b>	<b>2,547</b>	<b>198</b>

The weighted average price at the date of exercise of Sharesave options during the year was 477p (2006 345p) The options outstanding at 31 March 2007 had a weighted average exercise price of 240p (2006 198p) and a weighted average remaining contractual life of 1.9 years (2006 2.0 years)

The aggregate fair value of options granted during the year was £0.3m (2006 £0.3m), determined using the Black-Scholes valuation model The significant inputs into the valuation model were

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

## NOTES TO THE FINANCIAL STATEMENTS

### 28 Employee share schemes (continued)

#### i) Sharesave Scheme (continued)

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

#### ii) Restricted Share Plan

Under this plan, Directors and senior management receive a conditional award of ordinary 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 (which is related to the performance of the entire Pennon Group) over the restricted period, being not less than three years.

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

	2007		2006	
	Number of ordinary shares (thousands)	Weighted average price per share p	Number of ordinary shares (thousands)	Weighted average price per share p
At 1 April	618	287	732	228
Granted	145	499	189	357
Vested	(95)	195	(108)	213
Lapsed	(105)	270	(132)	213
Share consolidation	-	-	(63)	-
At 31 March	563	360	618	287

The awards outstanding at 31 March 2007 had a weighted average price of 360p (2006 287p) and a weighted average remaining contractual life of 1.2 years (2006 1.7 years). The Pennon Group Plc share price at the date of the awards ranged from 195p to 499p.

The aggregate fair value of awards granted during the year was £0.4m (2006 £0.4m), determined using a Monte-Carlo simulation model. The significant inputs into the valuation model were

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

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

## NOTES TO THE FINANCIAL STATEMENTS

### 28 Employee share schemes (continued)

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

Awards under the plan to Directors and senior management involve the release of ordinary shares in Pennon Group Plc to participants

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

	2007		2006	
	Number of ordinary shares (thousands)	Weighted average price per share p	Number of ordinary shares (thousands)	Weighted Average price per Share p
At 1 April	225	269	249	232
Granted	62	486	87	328
Vested	(122)	271	(81)	217
Lapsed	-	-	(9)	217
Share consolidation	-	-	(21)	-
At 31 March	165	349	225	269

The awards outstanding at 31 March 2007 had a weighted average price of 349p (2006 269p) and a weighted average remaining contractual life of 1.4 years (2006 1.5 years). The Company's share price at the date of the awards ranged from 217p to 486p.

The aggregate fair value of awards granted during the year was £0.3m (2006 £0.3m), determined from market value. No option pricing issues arise as dividends declared on the shares are receivable by the participants in the scheme and there is no performance condition since vesting is usually conditional upon continuous service with the Pennon Group for a period of three years from the award.

## NOTES TO THE FINANCIAL STATEMENTS

### 29 Retained earnings and other reserves

	Hedging reserve	Retained earnings	Total
	£m	£m	£m
At 1 April 2005	(0.9)	181.1	180.2
Profit for the year	-	18.5	18.5
Other recognised income and expense for the year	0.4	1.0	1.4
Dividends paid	-	(197.9)	(197.9)
Adjustment in respect of share-based payments	-	1.2	1.2
Deferred tax in respect of share-based payments	-	0.7	0.7
Adjustment in respect of share options vesting	-	(0.7)	(0.7)
<b>At 31 March 2006</b>	<b>(0.5)</b>	<b>3.9</b>	<b>3.4</b>
Profit for year	-	72.1	72.1
Other recognised income and expense for the year	14.7	(0.8)	13.9
Dividends paid	-	(75.0)	(75.0)
Adjustment in respect of share-based payments	-	1.2	1.2
Adjustment in respect of share options vesting	-	(0.4)	(0.4)
<b>At 31 March 2007</b>	<b>14.2</b>	<b>1.0</b>	<b>15.2</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 30 Cash flow from operating activities

Reconciliation of profit for the year to cash generated from operations

#### Cash generated from operations

	2007 £m	2006 £m
<b>Continuing operations</b>		
Profit for the year	72.1	18.5
Adjustments for		
Employee share schemes	1.2	1.9
Deferred income released to profits	(0.2)	(0.3)
Profit on disposal of property, plant and equipment	(2.4)	(1.4)
Depreciation charge	77.7	72.0
Interest payable and similar charges	79.8	130.9
Interest receivable	(21.6)	(34.3)
Taxation	26.3	12.0
Changes in working capital		
Increase in inventories	-	(0.3)
(Increase)/decrease in trade and other receivables	(5.9)	6.8
Increase in trade and other payables	-	8.5
Increase/(decrease) in retirement benefit obligations	1.4	(30.6)
Decrease in provisions for liabilities and charges	(1.3)	(1.4)
Cash generated from operations	<u>227.1</u>	<u>182.3</u>

### 31 Net borrowings

	2007 £m	2006 £m
Cash and cash equivalents	118.8	52.0
Loan to parent company	14.6	-
<i>Borrowings - current</i>		
Bank overdrafts	(13.9)	(20.7)
Other current borrowings	(16.3)	(39.2)
Finance lease obligations	(43.9)	(24.4)
<b>Total current borrowings</b>	<u>(74.1)</u>	<u>(84.3)</u>
<i>Borrowings - non current</i>		
Bank loans	(120.0)	(120.0)
Other non-current borrowings	(315.9)	(232.2)
Finance lease obligations	(1,029.5)	(920.9)
<b>Total non-current borrowings</b>	<u>(1,465.4)</u>	<u>(1,273.1)</u>
<b>Total net borrowings</b>	<u>(1,406.1)</u>	<u>(1,305.4)</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 32 Operating lease commitments – minimum lease payments

	2007 £m	2006 £m
Aggregate commitments under non-cancellable operating leases expiring		
Within one year	1.3	1.3
Later than one year and less than five years	5.0	5.0
After five years	20.1	21.2
	<u>26.4</u>	<u>27.5</u>

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

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

### 33 Contingent liabilities

	2007 £m	2006 £m
Guarantee of borrowings of subsidiary undertaking	<u>100.0</u>	<u>-</u>

The Company has guaranteed the principal and interest on £100m loan notes issued during the year by South West Water Finance Plc. If the 40 year swap rate is above 4.13% on 22 June 2010, the £100m of notes will be repaid in full at no penalty. If that rate is below 4.13% on 22 June 2010, then either the £100m can be repaid (with a penalty) or the notes will carry on until 2050 at a rate of 4.51% plus credit margin.

### 34 Capital commitments

	2007 £m	2006 £m
Contracted but not provided	<u>67.0</u>	<u>64.8</u>

### 35 Related party transactions

During the year, the Company entered into the following transactions with related parties:

<u>Parent company</u>	2007 £m	2006 £m
Purchase of goods and services		
Group expenses	3.7	3.4
Sale of goods and services		
Administrative services	0.5	0.5
Loan interest paid	-	12.8
Loan interest received	0.6	1.2
Dividends paid	75.0	197.9

## NOTES TO THE FINANCIAL STATEMENTS

### 35 Related party transactions (continued)

<u>Subsidiaries of the Company</u>	2007	2006
	£m	£m
Purchase of goods and services		
Property consultancy	0.5	0.1
Payment for provision of finance		
Loan interest	3.2	-
Finance lease charges vehicles	0.1	0.1
Finance lease charges plant & machinery	0.2	-
Sale of goods and services (administrative services)	0.2	0.2
Loan interest received	0.1	0.1
 <u>Fellow subsidiaries of the Pennon Group</u>		
Purchase of goods and services		
Sludge tankering and waste disposal	0.7	1.3
Insurance premia	0.8	0.8
Sale of goods and services		
Tankered waste and trade effluent charges	0.3	0.3
 <u>Joint venture</u>		
Purchase of goods and services		
Customer service and billing facilities	9.4	9.1
Sale of goods and services		
Administrative services	2.6	2.5
 <b>Year end balances</b>		
Borrowings (note 22)		
Loan from subsidiary	100.0	-
Finance lease balances with subsidiary	27.8	1.0
Receivables (notes 14 and 17)		
Parent company	14.7	1.2
Subsidiaries	1.7	1.5
Fellow subsidiaries	6.1	5.4
Joint venture	0.9	1.2
Payables (note 20)		
Parent company	0.1	2.3
Subsidiaries	1.6	0.1
Fellow subsidiaries	0.2	0.3
Joint venture	0.2	0.2

## NOTES TO THE FINANCIAL STATEMENTS

### 36 Explanation of transition to IFRS

South West Water Limited reported under UK GAAP in its previously published financial statements for the year ended 31 March 2006. The analysis below shows a reconciliation of net assets and profit as reported under UK GAAP as at 31 March 2006 to the revised net assets and profit under IFRS as reported in these financial statements. In addition, there is a reconciliation of net assets under UK GAAP to IFRS at the transition date which for the Company was 1 April 2005.

## NOTES TO THE FINANCIAL STATEMENTS

### 36 Explanation of transition to IFRS (Continued)

#### i) Balance Sheet Reconciliation at 31 March 2006

	Reported Under UK GAAP £m	Impact of IFRS				IFRS £m
		IAS 12 Tax £m	IAS 16 Infrastructure renewals £m	IAS 19 Pensions £m	Other £m	
<b>Assets</b>						
<b>Non-current assets</b>						
Investment in subsidiary undertakings	3 3					3 3
Investment in joint ventures	2 0				(1 9)	0 1
Property, plant and equipment	2,164 1		(4 1)		(16 9)	2,143 1
Trade and other receivables	1 5					1 5
	<u>2,170 9</u>		<u>(4 1)</u>		<u>(18 8)</u>	<u>2,148 0</u>
<b>Current assets</b>						
Inventories	4 0					4 0
Trade and other receivables	44 1				2 5	46 6
Derivative financial instruments	2 5					2 5
Cash and cash equivalents	52 0					52 0
	<u>102 6</u>				<u>2 5</u>	<u>105 1</u>
<b>Liabilities</b>						
<b>Current liabilities</b>						
Derivative financial instruments	(3 0)					(3 0)
Borrowings	(84 3)					(84 3)
Trade and other payables	(101 6)				1 0	(100 6)
Current tax liabilities	(3 0)					(3 0)
Provisions for liabilities and charges	(1 3)					(1 3)
	<u>(193 2)</u>				<u>1 0</u>	<u>(192 2)</u>
<b>Net current liabilities</b>	<u>(90 6)</u>				<u>3 5</u>	<u>(87 1)</u>
<b>Non-current liabilities</b>						
Borrowings	(1,273 1)					(1,273 1)
Other non-current liabilities	(18 1)				15 9	(2 2)
Retirement benefit obligations	(24 1)			(10 9)		(35 0)
Deferred tax liabilities	(86 9)	(220 3)	0 6	10 3		(296 3)
	<u>(1,402 2)</u>	<u>(220 3)</u>	<u>0 6</u>	<u>(0 6)</u>	<u>15 9</u>	<u>(1,606 6)</u>
<b>Net assets</b>	<u>678 1</u>	<u>(220 3)</u>	<u>(3 5)</u>	<u>(0 6)</u>	<u>0 6</u>	<u>454 3</u>
<b>Shareholders' equity</b>						
Share capital	450 9					450 9
Retained earnings and other reserves	227 2	(220 3)	(3 5)	(0 6)	0 6	3 4
<b>Total shareholders' equity</b>	<u>678 1</u>	<u>(220 3)</u>	<u>(3 5)</u>	<u>(0 6)</u>	<u>0 6</u>	<u>454 3</u>

The UK GAAP balances have been restated in IFRS format

## NOTES TO THE FINANCIAL STATEMENTS

### 36 Explanation of transition to IFRS (Continued)

#### ii) Income Statement Reconciliation for the year ended 31 March 2006

	Reported Under UK GAAP £m	Impact of IFRS				IFRS £m
		IAS 12 Tax £m	IAS 16 Infrastructure renewals £m	IAS 19 Pensions £m	Other £m	
<i>Continuing operations</i>						
<b>Revenue</b>	351.5				(2.9)	348.6
<b>Operating costs</b>						
Manpower costs	(31.8)					(31.8)
Raw materials and consumables used	(12.8)					(12.8)
Other operating expenses	(100.2)		(6.6)		1.9	(104.9)
Depreciation	(81.0)		8.0		1.0	(72.0)
<b>Operating profit</b>	125.7		1.4		-	127.1
Interest payable and similar charges	(130.9)					(130.9)
Interest receivable	34.3					34.3
<b>Profit before tax</b>	29.1		1.4			30.5
Tax on ordinary activities	3.5	(6.9)	0.6	(9.2)		(12.0)
<b>Profit for the year</b>	32.6	(6.9)	2.0	(9.2)	-	18.5
Profit attributable to equity shareholders	32.6	(6.9)	2.0	(9.2)	-	18.5

The UK GAAP balances have been restated in IFRS format

## NOTES TO THE FINANCIAL STATEMENTS

### 36 Explanation of transition to IFRS (Continued)

#### iii) Balance Sheet Reconciliation at 1 April 2005

	Reported Under UK GAAP £m	Impact of IFRS				IFRS £m
		IAS 12 Tax £m	IAS 16 Infrastructure renewals £m	IAS 19 Pensions £m	Other £m	
<b>Assets</b>						
<b>Non-current assets</b>						
Investment in subsidiary undertakings	3 3					3 3
Investment in joint ventures	1 9				(1 8)	0 1
Property, plant and equipment	2,051 1		(5 6)		(17 9)	2,027 6
Trade and other receivables	1 0					1 0
	<u>2,057 3</u>		<u>(5 6)</u>		<u>(19 7)</u>	<u>2,032 0</u>
<b>Current assets</b>						
Inventories	3 6					3 6
Trade and other receivables	46 1				2 2	48 3
Cash and cash equivalents	238 7					238 7
	<u>288 4</u>				<u>2 2</u>	<u>290 6</u>
<b>Liabilities</b>						
<b>Current liabilities</b>						
Derivative financial instruments	(0 9)					(0 9)
Borrowings	(47 7)					(47 7)
Trade and other payables	(70 3)				1 0	(69 3)
Current tax liabilities	(6 5)					(6 5)
Provisions for liabilities and charges	(1 9)					(1 9)
	<u>(127 3)</u>				<u>1 0</u>	<u>(126 3)</u>
<b>Net current assets</b>	<u>161 1</u>				<u>3 2</u>	<u>164 3</u>
<b>Non-current liabilities</b>						
Borrowings	(1,220 8)					(1,220 8)
Other non-current liabilities	(19 3)				16 9	(2 4)
Retirement benefit obligations	(46 7)			(20 3)		(67 0)
Deferred tax liabilities	(80 8)	(213 4)		20 0		(274 2)
Provisions for liabilities and charges	(0 8)					(0 8)
	<u>(1,368 4)</u>	<u>(213 4)</u>		<u>(0 3)</u>	<u>16 9</u>	<u>(1,565 2)</u>
<b>Net assets</b>	<u>850 0</u>	<u>(213 4)</u>	<u>(5 6)</u>	<u>(0 3)</u>	<u>-</u>	<u>631 7</u>
<b>Shareholders' equity</b>						
Share capital	450 9					450 9
Retained earnings and other reserves	399 1	(213 4)	(5 6)	(0 3)	-	180 2
<b>Total shareholders' equity</b>	<u>850 0</u>	<u>(213 4)</u>	<u>(5 6)</u>	<u>(0 3)</u>	<u>-</u>	<u>631 1</u>

The UK GAAP balances have been restated in IFRS format

## NOTES TO THE FINANCIAL STATEMENTS

36 Explanation of transition to IFRS (Continued)

iv) Notes to the reconciliation of net assets and profit

### First time adoption

IFRS 1 “First-time Adoption of International Financial Reporting Standards” requires that IFRS be applied retrospectively unless a specific exemption is applied. In preparing these financial statements the Company has adopted the following exemptions:

- To establish a deemed cost for the opening balance sheet carrying value of the water and wastewater infrastructure fixed assets by reference to the fair value of these assets at the date of transition to IFRS, 1 April 2005. All non-infrastructure assets have been carried forward on transition using the depreciated historical cost UK GAAP balances as the deemed IFRS costs,
- Not to apply the requirements of IFRS 2 “Share-Based Payment” to options granted under the Group’s share incentive schemes prior to 7 November 2002.

### Property, plant and equipment

UK GAAP (FRS 15) permitted the use of “renewals accounting” as a method for estimating depreciation on infrastructure assets and was adopted by the UK water industry. The depreciation charge represented the level of annual expenditure required to maintain the operating capacity of the infrastructure network at a specified level of service potential by the continuing replacement and refurbishment of its components. The Company used an independently certified Asset Management Plan to determine the level of annual expenditure required.

IFRS does not permit the use of renewals accounting. Instead infrastructure assets are capitalised and depreciated over the estimated useful lives of major components.

Infrastructure assets in the opening balance sheet under IFRS have consequently been restated from their existing UK GAAP net book value. In accordance with the first time adoption rules set out in IFRS 1, fair value has been used as deemed cost of the infrastructure assets on restatement. This value is depreciated over the estimated remaining asset life.

Shareholders’ equity at 31 March 2005 has not been significantly affected since the opening fair value of infrastructure assets under IFRS was close to the net book value under UK GAAP.

Reported operating profit for the year ended 31 March 2006 has been increased by £1.4m as a result of calculating specific depreciation compared to the previous normative long-term charge based upon the 1999 Periodic Review Asset Management Plan.

The Company has also reclassified all grants and contributions received for non-infrastructure assets from deferred income to property, plant and equipment, totalling £19m.

## NOTES TO THE FINANCIAL STATEMENTS

36 Explanation of transition to IFRS (Continued)

iv) Notes to the reconciliation of net assets and profit (Continued)

### Retirement benefits

Under UK GAAP (FRS 17), deferred tax relating to a defined benefit pension scheme asset or liability is shown separately from other deferred tax as a deduction from the asset or liability and the movement on the deferred tax shown in the Statement of Total Recognised Gains and Losses rather than a charge or credit against the profit for the year. Under IFRS (IAS 19), deferred tax related to a defined benefit pension scheme asset or liability is included with other deferred tax balances, and is not shown as a deduction from the pension asset / liability. The movement in the deferred tax is shown as part of the tax charge for the year.

At 31 March 2006 the deferred tax asset of £10.3m previously deducted from the gross pension scheme liability of £34.4m is now included with other deferred tax balances under the balance sheet heading 'Deferred tax liabilities'. The movement in the year of £9.2m is now shown within the tax charge for the year rather than as a direct charge to equity.

Under UK GAAP (FRS 17), the fair value of quoted securities is taken as the mid-market value. Under IFRS (IAS 19), current bid price is used. This results in a reduction in the fair value of pension scheme assets at 31 March 2006 of £0.6m.

### Deferred taxation

Under UK GAAP the Company created a discounted provision for deferred taxation, as allowed under FRS 19, to reflect an assessment of the period over which timing differences are expected to reverse.

Under IFRS a discounting methodology is not permitted and consequently the deferred tax provision increases, with a commensurate reduction to shareholders' equity, as indicated below.

	31 March 2006 £m	31 March 2005 £m
Discounted provision – UK GAAP	87	81
Undiscounted provision – IFRS	307	294
Increase in provision	<u>220</u>	<u>213</u>

The amount of deferred tax charged against 2005/06 profits increased from £7m under UK GAAP to £14m under IFRS, through the impact of not discounting liabilities.

The significant on-going level of capital expenditure projected for the Company's operations means that actual payment of tax is expected to continue to be deferred through the creation of further timing differences.

### Other differences

All other differences between IFRS and UK GAAP are included within the "Other" column.

The only difference impacting the level of net assets relates to IFRS 2 "Share-based payment". The Company adopted FRS 20 "Share-based payment", the accounting requirements of which are the same as IFRS 2, in the financial statements for the year ended 31<sup>st</sup> March 2006.

## NOTES TO THE FINANCIAL STATEMENTS

36 **Explanation of transition to IFRS (Continued)**

iv) **Notes to the reconciliation of net assets and profit (Continued)**

### **Other differences (Continued)**

In November 2006 IFRIC Interpretation 11 “IFRS 2 – Group and Treasury Transactions” was issued, clarifying the accounting treatment where a parent grants rights to its equity instruments direct to the employees of its subsidiary, with the parent having the obligation to provide the employees of the subsidiary with the equity instruments needed. As a result of this clarification, payments by the Company to Pennon Group Plc for shares under its share schemes are now debited to inter-company receivables rather than debited to listed investments. The amount charged to the income statement is not affected.

### **v) Cash flow statement**

The move from UK GAAP to IFRS does not change any of the cash flows of the Company. The IFRS cash flow format is similar to UK GAAP but presents some cash flows in different categories and in a different order from the UK GAAP cash flow statement. All of the IFRS adjustments net out but differences in disclosure arise from the change in treatment of infrastructure assets (see above) and the inclusion of liquid investments with a maturity of less than three months as cash and cash equivalents under IFRS.