

# **SOUTH WEST WATER LIMITED**

## **ANNUAL REPORT AND FINANCIAL STATEMENTS 2008**

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



# ANNUAL REPORT AND FINANCIAL STATEMENTS 2008

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## CHIEF EXECUTIVE'S REVIEW

It has been another successful year for South West Water. Improvements have been made to both operational and customer service whilst providing a satisfactory return for shareholders.

This year South West Water has been laying the foundations for the future. Our vision, 'Pure Water, Pure Service and Pure Environment' was launched during 2007 and is being used as the basis for our plans now and for the next 25 years.

The vision defines the following aspirations for South West Water:

- Pure Water – investment in maintaining our assets to give our customers the highest quality drinking water
- Pure Service – improving the services that customers experience
- Pure Environment – delivering sustainable sewerage services for the region's benefit

Underpinning the vision is the strategy of striking the right balance between investing to improve our services, financeability and, importantly, customer affordability.

We must meet ongoing regulatory requirements. The Government's new water strategy for England, 'Future Water', was published in February 2008. The themes of the South West Water vision are echoed in the Government's strategy and the key challenges of addressing future requirements for water supply and demand, water quality in our natural environment, the impacts of climate change, and tackling customer affordability, form a significant part of our strategy.

The new vision and strategy for South West Water formed the basis of our early work in preparation for the next periodic review due in 2009.

- In December 2007 we published our Strategic Direction Statement which sets out our aspirations and the challenges we face in pursuing our Pure Water, Pure Service and Pure Environment vision over the next 25 years.
- In March 2008 we issued our draft Water Resources Plan, which sets out our strategy to ensure that all customers have a secure supply of water for the next 25 years.

Developing the 'Pure' framework has assisted South West Water in focusing on delivering a strong performance over the past 12 months.

We have made excellent progress with our focused objectives of:

- Improving service to customers and tackling affordability issues
- Completing required investment in our assets and infrastructure for the benefit of our customers and the environment
- Improving operating efficiencies

Delivery against our long-term aspirations set out in our vision has already started.

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

### ***Pure Water***

To progress the Pure Water vision, there have been a number of key achievements during the year

- This has been our 11th consecutive year without water restrictions. Persistent rain during the summer months, followed by below average rainfall during the winter months have tested our supply-demand resilience. The company has put in place a comprehensive strategy to help ensure a continued secure supply of water for the region. Customer satisfaction with the reliability of the supply received from South West Water is at its highest ever level of 94%.
- Projects have been delivered to modernise our infrastructure, such as a major upgrade for Littlehempston Water Treatment Works, which serves 160,000 homes in Torbay and South Devon.
- We achieved our target leakage performance of 84 Megalitres per day (Ml/d). We have achieved or beaten our leakage target in every year since targets were introduced by Ofwat in 1999/2000.
- One of the most significant elements of the current (2005-2010) investment programme is water mains renovation. A further 479.9km of water mains were replaced or relined during the year as part of the company's ongoing 'Putting the Sparkle Back into Your Water' programme, agreed with the Drinking Water Inspectorate (DWI) for completion by 2010. Four key programme milestones have now been successfully achieved. Work for the fifth and final milestone is under way and is due to be completed before 2010.
- Drinking water quality overall compliance for calendar year 2007, as monitored by the DWI, achieved its highest ever level of 99.97% compared to the 99.96% level achieved in 2005 and 2006.

### ***Pure Service***

This year a number of projects have been delivered to progress the Pure Service vision

- Accenture was awarded to the customer service and billing contract, giving us the opportunity for a step change in customer service through quality improvements and more efficient ways of working.
- A new contact centre system was installed to improve our call-handling services for customers using our helplines. The benefits of the new system are already being seen, with a significant improvement in capacity and 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. Customers are advised on how to manage better both their water use and household budget, including claiming all the benefits, to which they are entitled. Some customers benefit from moving on to a special payment plan which enables them to make regular affordable payments, thereby reducing the company's outstanding debt. During 2007/08, WaterCare has delivered tangible benefits to nearly 2,000 customers and has been commended by the Government as an exemplary service offered to customers.
- The Company improved its position in both the 'Water and Sewerage Companies' and 'All Companies' league tables in Ofwat's Overall Performance Assessment (OPA) for 2006/07, with a best ever ranking of fifth out of ten among the water and sewerage companies compared with our sixth place in 2005/06.
- We won first place in the sustainability category of the Water Industry Achievement Awards 2008 for our work in assisting business customers to save money and conserve water.

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

### ***Pure Environment***

The environment is a continuing focus for South West Water, building on the success of our coastal clean-up programme, the 'Clean Sweep'. Our work to improve the natural environment in the South West this year included

- Investments to increase capacity at a number of sewage treatment works and deliver environmental benefits by treating previously untreated sewage
- Continuing investment in coastal waste water improvements. Despite the wettest summer on record compliance with the Mandatory EU bathing water standard was 97.9%. This slight reduction on the previous year was considered to be primarily due to agricultural and surface water run-off. We also contributed to the achievement of 78.3% compliance with the EU's strictest Guideline bathing water standard, compared to only 47.5% compliance ten years ago.
- The percentage of the population served by sanitary-compliant waste water treatment works was the highest ever at 99.73% in calendar year 2007.
- Promotion of innovative work in some of our wider water catchments to improve natural water retention and the quality of water reaching our reservoirs and abstraction points. The projects are being undertaken with land owners and users, and a wide range of statutory and voluntary organisations.

Underpinning the vision is the need to further drive operational efficiencies and create opportunities to enable further improvements to operational and customer service performance. South West Water has continued to do this in the following ways

- Investment has been made this year in the infrastructure to move the organisation towards a more centralised operational structure employing increased levels of automation and remote working.
- A significant programme of organisational restructuring across the business has been ongoing through the year costing £4m, leading to increased operational efficiency.
- To support the step changes in operational and service improvements a number of employee development programmes are being undertaken, developing staff across the business. During the year, 26 employees were awarded, and 67 employees were working towards completing, National Vocational Qualifications.
- A 'rightsourcing' review was completed this year ensuring we have the optimal combination of internal and external resource provision. This led to a number of improvements to existing outsourcing arrangements, in particular leading to changes in the way we manage our water distribution network.

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

### ***Financial Review***

2007/8 has been another successful year for South West Water, delivering further value for shareholders through a strong set of operational, financial and regulatory results whilst improving customer service

Underlying operating profit (operating profit before restructuring costs of £4 0m (2007 £0 3m)) up by £28 2m to £185 1m, despite a £7 9m (4 1%) fall in measured demand (2007/08 saw the wettest summer in decades)

The company's revenue increased by £39 5m to £421 3m

- Significant increases Ofwat approved tariff increases (£52 3m) and 8,300 new customer connections (£3 6m)
- Significant decreases customers switching to metered tariffs (£10 0m) and a 4 1% fall in measured demand (£7 9m)

Over 62% of our domestic customers now receive a metered supply

Operating costs, excluding depreciation and restructuring costs, increased by £4 0 million to £151 2 million

- Efficiency savings £4 2m in the year, an £11 2m cumulative base cost reduction since 2005
- Additional costs from new capital schemes £1 1m
- Inflation of £2 3m (net of a reduction in power costs of £2 5m)
- Other costs increased by £4 5m after lower property disposals of £2 6m in the year

The cost of bad debts rose more slowly than the tariff increase.

We are on track to deliver the demanding efficiency targets set by Ofwat at the last Determination over the 2005-2010 period

Capital expenditure was £169 6 million with over £68 million being spent on quality schemes, principally water mains rehabilitation

Further analysis of the financial results achieved in the year is presented within the Business Review on page 8

Looking forward, there is a significant programme of change underway that will deliver benefits to all stakeholders into the next Periodic Review I am confident that through the professionalism and dedication of our people at all levels within our organisation we will move towards achieving our vision of 'Pure Water, Pure Service, Pure Environment'

**C Loughlin**  
**Chief Executive**

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

Chairman	K G Harvey
Chief Executive	C Loughlin
Operations Director	S C Bird
Finance Director	S J Davy
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 nineteenth Annual General Meeting of South West Water Limited will be held at Peninsula House, Rydon Lane, Exeter on 22 July 2008 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 2008
- 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

27 June 2008

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 2008

### **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**

South West Water turnover rose by £39.5m to £421.3m. Approved tariff increases, including the 9.8% K factor, amounted to £52.3m and 8,300 customer connections contributed an additional £3.6m. However, 28,700 customers switching from unmeasured to metered charging (with each customer saving an estimated £340 on their annual bill) caused a reduction of £10.0m in turnover. 62% of South West Water's domestic customers are now metered – up from 57% at March 2007. A 4.1% decrease in measured demand, impacted in part by the wettest summer since records began, reduced turnover by £7.9m.

Operating profit rose by 15.6% to £181.1m. Underlying operating profit before restructuring costs of £4.0m (2007 £0.3m) rose by 18.0% to £185.1m. Operating efficiencies of £4.2m made a strong contribution to offsetting other additional costs, mainly arising from increased depreciation and operating costs from new and improved works of £8.1m and inflation of £2.3m (net of a reduction in power costs of £2.5m). The cost of bad debts is rising more slowly than the tariff increase.

A significant programme of organisational restructuring across the business has been going on through the year costing £4.0m, leading to increased operational efficiency.

Net interest cost rose by £6.7m (11.5%) to £64.9m. Net interest receivable on pension scheme assets and liabilities was £1.0m lower than in the previous year with a decrease of £0.8m on the expected return on pension scheme assets combined with an increase in the interest cost of retirement benefit obligations of £0.2m. The remaining increase of £5.7m reflects an increase in net borrowings during the year of £49.1m to £1,455.2m and higher interest rates on variable rate borrowings.

The mainstream corporation tax charge for the year was £18.5m (2007 £15.2m) giving a mainstream effective tax rate of 16%. Deferred tax for the year was a credit of £7.9m (2007 charge of £11.1m) resulting from a non-recurring credit of £20.5m relating to the reduction in the rate of UK corporation tax from 30% to 28% (effective from 1 April 2008). The abolition of industrial building allowances is expected to be enacted in 2008/09 and is then expected to increase deferred tax by an estimated £30m.

#### **Investment**

High levels of investment in the Company's infrastructure were maintained in the year. Capital expenditure was £169.6m compared to £183.9m in 2006/07. £100.0m was invested in water supply improvements including water mains renovation and water treatment works enhancement. The water treatment works at Littlehempston in South Devon, serving 160,000 homes in the Torbay area, was substantially upgraded.

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

Continued high levels of investment in the £240m water mains renovation programme to replace or reline 3,200 kms of water mains is a key element during the K4 period. A further 480km of water mains were laid, replaced or relined during the year, in line with the DWI's agreed programme for completion by 2010.

Drinking water quality compliance for calendar year 2007, as monitored by the DWI, achieved the highest ever level of 99.97% compared to the 99.96% achieved in 2005 and 2006.

Ofwat's latest report on leakage confirms that South West Water remains one of the leading companies in managing water leakage and continues to achieve Ofwat's target of keeping leakage at or below 84MI/d. The Company has achieved Ofwat's leakage targets every year since their inception. In 2007/08 it maintained its low level of leakage and continues to have one of the very lowest levels in the industry.

2007/08 was the 11th consecutive year without water restrictions. Persistent rain during the summer months, followed by below average rainfall during the winter months have tested the supply-demand resilience of the Company's network. The company has put in place a comprehensive strategy to help ensure a continued secure supply of water for the region. The Company is benefiting from the infrastructure installed several years ago which enables the pumping of water into a number of key reservoirs from downstream to supplement the natural inflow. Customer satisfaction with the reliability of the supply received from South West Water is at its highest ever level of 94%.

Waste water treatment works performance in 2007 was at an all time high. The region features the highest proportion of high quality rivers in England. Investment expenditure totalled £69.6m for the year and included one of the last remaining Clean Sweep projects at Sennen and Porthcurno. The Company's 15 year original 'Clean Sweep' coastal sewage treatment project has transformed the coastal environment around the South West. 97.9% compliance with EU bathing water standards was achieved in the year, despite the wettest summer on record. This result, lower than the 100% achieved last year, is considered to be primarily due to agricultural and surface water run-off, but in 2007 the Company contributed to the achievement of 78.3% compliance with the EU's strictest guideline bathing water standard, lower than the 92% recorded last year, but compared to only 47.5% compliance with the guideline standard ten years ago.

There has also been investment at a number of sewage treatment works to increase capacity and deliver environmental benefits by treating previously untreated sewage.

Investment has also been made in the infrastructure to move the organisation towards a more centralised operational structure employing increased levels of automation and remote working.

### **Financing**

Net borrowings increased in the year by £49.1m to £1,455.2m. The ratio of debt to Regulatory Capital Value (RCV) was at circa 60% at 31 March 2008 (2007 62%), within Ofwat's 'optimum range' of 55% - 65%.

During the year, the Company's subsidiary, South West Water Finance Plc, issued £200.0m 1.99% index-linked bonds (guaranteed by the Company) for proceeds of £206.7m, giving a real rate of 1.86%, and then lent the same amount to the Company on similar terms.

The Company also sold and leased back under finance lease arrangements some £100.0m of plant, property and equipment.

## REPORT OF THE DIRECTORS (continued)

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 £80.0m at 31 March 2008.

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.

Dividend payments are designed to ensure that key financial ratios are not prejudiced and that the ability of the Company to finance its regulated business is not impaired.

The Company's ability to pay dividends is limited by the balance on distributable reserves, which has been reduced by the IFRS requirement for deferred tax to be provided on an undiscounted basis. 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.

During the year dividends totalling £68.7m (2007 £75.0m) were paid, comprising £45.7m base dividend relating to 2006/07 and £23.0m in outperformance dividends. These were calculated with reference to the projections in the Final Determination 2005-2010. A base dividend for 2007/08 (£48.8m) has not yet been paid, and £3.6m of the 2006/07 outperformance dividend remains outstanding.

### Principal risks and uncertainties

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

<b>Risk</b>	<b>Mitigation</b>
Tighter price controls over the revenue of the Company's regulated business could adversely affect profitability.	South West Water has met Ofwat's efficiency expectations in the last two Periodic Review periods and is on track to meet them in the current period.

## REPORT OF THE DIRECTORS (continued)

<b>Risk</b>	<b>Mitigation</b>
Failure to deliver the capital investment programme could adversely affect future profitability	The Company has a track record of delivering its capital programme in accordance with regulatory requirements The current capital programme is on track and progress is regularly monitored and reviewed
The company may be unable to raise sufficient funds to finance its functions	Pennon Group and the Company have robust treasury policies in place. These include policies that there are always pre-drawn or committed facilities to cover at least one year's estimated cashflow and that no more than 20% of borrowing matures in any one year
Failure to deliver operating cost savings implicit in the regulatory review could adversely affect profitability	In line with its track record, the Company remains confident of delivering the assumed operating cost savings. A major restructuring programme is currently being implemented
Environmental regulations and quality standards could increase the company's costs and adversely affect profitability	These issues are addressed through the 5 year regulatory review mechanism
Climate change	The Company has plans ready and will adapt the way it conducts its business to respond effectively to the hotter, drier summers and wetter winters which are anticipated
Contamination to water supplies could adversely affect profitability	The Company has established procedures and controls in place, as well as contingency plans and incident management procedures. It also maintains insurance policies in relation to these risks, although there can be no assurance that all or any of the costs associated with these risks would be covered or that coverage will continue to be available in the future
Non-recovery of customer debt could adversely affect profitability	In addition to existing strategies, South West Water is implementing new initiatives to improve and secure cash collection, including the use of property charging orders. Provision was made in the last Periodic Review for companies to make an application for an Interim Determination in the event of bad debts being significantly above the amount allowed by the water regulator
Energy cost pressures	South West Water mitigates rising energy costs through careful system operation, by maximising renewable energy generation and by purchasing all forms of energy in the most efficient way

## REPORT OF THE DIRECTORS (continued)

<b>Risk</b>	<b>Mitigation</b>
Pension costs may increase due to factors outside the Company's control	Employer costs were reduced from 1 April 2006 through the closure of the existing defined benefit scheme to new entrants (replaced by a new scheme with reduced benefits) and an increase in employee contributions. From 1 April 2008 the new defined benefit scheme was also closed to new entrants and replaced by defined contribution arrangements. Employee and employer contributions have also been further increased.
Water resource adequacy	<p>The Company has a number of schemes in place to maintain water resources (such as pumped storage for certain reservoirs) and promotes conservation measures.</p> <p>In particular, South West Water prepares a new Water Resources Plan every five years and reviews it annually for a range of climate change and demand scenarios. The Water Resources Plan indicates that no new reservoirs are required before the planning horizon of 2035. However, investment is needed to develop the overall trunk main infrastructure, to expand treatment capacity and to enhance certain pumped storage facilities.</p>
Operational failures	The Company is able to monitor its significant assets by automated and remote operation and has routine controls and operating procedures in place that are constantly kept under review. Asset management techniques are employed to pre-empt the failure of assets.
Reduced revenue from falling customer demand for water	The water regulator is proposing a form of revenue cap regulation from 2010, which would allow water companies to recover a shortfall in income for a five year regulatory period in the next period.
Meter option take-up being greater than forecast	An interim Determination may be used to fully or partially recover revenue losses if they exceed the prescribed materiality threshold.

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.

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

### **Key Performance Indicators (KPI's) – Pure Water**

#### **Drinking Water Compliance**

During 2007, South West Water maintained its high level of overall compliance with the drinking water quality regulations with 99.97% of its regulatory tests meeting the required standards, an improvement on the 2006 and 2005 performances of 99.96%

#### **Abstraction, Supply and Leakage Control**

In 2007/8, South West Water abstracted 170,313MI of raw water from its 81 licensed abstraction locations which have a total licensed volume of 385,466MI. The abstraction sources are reservoirs and rivers, accounting for 90% of supplies, with 10% drawn from groundwater aquifers.

### **Key Performance Indicators – Pure Service**

#### **Overall Performance Assessment**

The Overall Performance Assessment (OPA) index is maintained by Ofwat as a comparative tool to measure companies' performance. The OPA is based on performance in areas such as customer service and complaint handling, billing, debt collection, asset serviceability, environmental compliance and quality of drinking water delivered. In 2006/07 South West Water improved its position to fifth among the 10 water and sewerage companies, compared with sixth in 2005/06.

#### **Customer Satisfaction**

In April 2005, Ofwat introduced a new measure for the overall manner in which a customer call was handled. The measure is obtained by quarterly tracking surveys undertaken by an independent company engaged and managed by Ofwat. Results are provided to the Company. The data has been averaged for the year to assess a performance trend. For 2007/08 the satisfaction score was 4.53, compared to 4.36 for 2006/07. The maximum score is 5.0 and at December 2007, Ofwat ranked the Company in sixth position of the ten water and sewerage companies.

### **Key Performance Indicators – Pure 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.

#### **Waste Water Treatment Compliance**

The percentage of the population served by sanitary compliant waste water treatment works in 2007 improved to 99.73%, compared with 99.58% in 2006. This performance contributes to South West Water's region having the highest percentage length of high quality rivers in England.

#### **Incidents and Prosecutions**

Five 'category two' (significant pollution incidents) were recorded by the Environment Agency in 2007/08, all of which were deemed non-compliant with discharge consents. This compares with five incidents in 2006, four of which were deemed non-compliant. During the year, the Company was convicted on eight occasions for environmental offences and fined a total of £36,100 compared with seven convictions and £30,000 in fines in 2006/07. There was also a Drinking

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

Water Inspectorate prosecution in the year in respect of water supplies for a small part of Exeter  
The Company was fined £5,000 each on four charges

The Company always self reports incidents it becomes aware of and seeks to cooperate with any investigation with the relevant Regulatory Authority After each pollution incident, including incidents leading to prosecution, the Company takes such steps as are necessary to ensure that the incident will not be repeated and also seeks to ensure that lessons learned are widely disseminated throughout the Company

### **Bathing Water Performance**

Our investment in waste water performance over the last eighteen years is an important contributor to the region having a significant proportion of the finest bathing waters, beaches and rivers in the UK In 2007, all but three of the region's 143 bathing waters (usually 144 but one private beach was closed in 2007) bathing waters achieved the EU Mandatory standard (100% in 2006) and 78.3% achieved the more stringent Guideline standard (91.7% in 2006) The bathing water results in 2007 were affected by an exceptionally wet summer which led to increased run-off from land

### **Key Performance Indicators – Financial and Business**

#### **Growth in Regulatory Capital Value**

RCV is the financial base used by Ofwat to allow a rate of return and set prices at each periodic review The RCV at 31 March 2008 amounted to £2.408 billion This compares with £2.265 billion at 31 March 2007, an increase of 6.3% From 31 March 2005 to 31 March 2010 we are expecting a 36% growth in RCV, the highest percentage increase of any quoted water company

Future RCVs up to 2009/10 are based upon Ofwat's projections These were set out in 'Future Water and Sewerage Charges 2005 -10' published in December 2004 and have been adjusted by South West Water's estimates of outturn prices The growth in RCV adds directly to shareholder value as the allowed return is attributed to South West Water's asset base by the water regulator

#### **Operating Profit**

South West Water achieved an underlying operating profit of £185.1m in 2007/8, up £28.2m rise on 2006/07 before £4.0m restructuring costs in 2007/8 (restructuring costs £0.3m in 2006/07)

### **Key Performance Indicators – Health and Safety Performance**

Occupational health and safety are key elements of South West Water's risk management and internal control processes South West Water's reportable accident rate remains an important KPI and the number of reportable accidents continues to fall as we improve the skills of our personnel and make their working environment safer

We continue to pursue initiatives to improve further the health and safety of our employees through the provision of training and promotion of health and safety These are designed to ensure that employees have the knowledge and expertise to undertake their jobs in a wellmotivated, contented and productive manner

The Company had its lowest number of reportable accidents in 2007 at 8.55 accidents per 1,000 employees compared with 11.55 accidents per 1,000 employees in 2006 and 12.56 per 1,000 employees in 2005

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

### **Customer, Community and Employees**

#### **Customers**

Customers are kept informed through a company newspaper 'WaterLevel', leaflets, the media and our website, [www.southwestwater.co.uk](http://www.southwestwater.co.uk). Detailed research and consultation has been undertaken with customers and stakeholders in relation to the Periodic Review process.

During the summer our customer caravan visits the Devon and Cornwall county shows as well as other fairs and events throughout the region. Staff help with customer enquiries and provide information about water conservation, how we invest, our assets and our services.

We meet regularly with the Customer Council for Water (CC Water), which champions water customers. We regularly consult CC Water and other stakeholders such as pensioners' forums and citizens' advice bureaux, prior to major changes or initiatives.

Our 'Customer Plus' programme is aimed at transforming our customer service and making it amongst the best in the industry. Working with Accenture we will be investing £4 million in improving customer service.

We publish our 'Customer Promise', setting out clearly how we will respond when things go wrong and what we will do to put them right.

Staff across the company deliver a 'company talk' to community groups and water conservation staff provide a school talks service for young people.

Our monthly customer satisfaction survey shows rising customer satisfaction with South West Water's service.

#### **Community and Sponsorship**

South West Water concentrates its sponsorship on community projects and organisations within its service area which are linked to water, benefit the environment or promote youth participation.

Highlights in 2007/8 included the company's first involvement in green arts as lead sponsor of TRAIL – an exhibition of environmental sculptures on the South West Coast Path – and a joint project with South West Lakes Trust to plant a new natural woodland at Wimbleball Lake.

The company also took the opportunity to co-sponsor South West Tourism's annual awards and fund a new sustainable tourism prize to demonstrate how the Clean Sweep project has helped underpin the renaissance of the region's number one industry since 1989.

Youth participation projects included sponsoring a national junior championship in Cornwall run by the Surf Life Saving Association of Great Britain and Exmouth's first kite festival. In total, 64 organisations and schemes across the region were sponsored.

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

### **Employees**

The average number of employees during the year was 1,276 compared to 1,301 last year. Details of the related costs can be found in note 10 to the financial statements on page 37.

The Company is focused on developing well trained and motivated employees in order to achieve the Pure Water, Pure Service and Pure Environment vision and to successfully meet the growing expectations in customer service, operational outputs and cost efficiency.

A new employee development framework co-ordinates training and development for all employees and better outlines and explains what the company offers and what employees are required to do in support of their own personal development. A new graduate development programme was created and launched in early 2008 involving around 60 current graduate employees within the organisation. All training activities are undertaken under the 'Investor in People' (IIP) standard, which is closely aligned with business requirements.

South West Water continues to drive change management programmes and take advantage of new technology. Two examples are the creation of the new service centre at the company's headquarters in Exeter and further deployment of mobile computing to improve the efficient operation of the workforce in the field.

In pursuing efficiency projects, the Company is engaging employees in the design and development of business improvements. Further initiatives include reviewing and improving work activities, employee practices and delivering more flexible terms and conditions in key operational areas affecting service provision to customers. Negotiations in craft and industrial areas regarding terms and conditions of employment are progressing well and these are linked to improved training and development and broader progression schemes.

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 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.

South West Water continues to play a major role in 'Clear Water 2010', a 10-year occupational health programme for the water industry. The Company continues to pursue initiatives to further improve the health and safety of its employees through the provision of training and promotion of health and safety initiatives to ensure that employees continue to have the knowledge and expertise to undertake their jobs safely.

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

### **Key Relationships**

#### **Regulators and others**

Relationships with regulators, Government and its agencies, customer representative organisations and its customers are central to South West Water's operations. The Company maintains a continuing dialogue with Ofwat, the Environment Agency and the Drinking Water Inspectorate. It contributes to national policy on developing issues through its membership of Water UK, the industry trade body. The Company works with the Consumer Council for Water to ensure that customers' issues and concerns are addressed and a full understanding of the Company's activities is maintained.

#### **Procurement and Suppliers**

South West Water's procurement strategy is focused on the management of 60 key and strategic suppliers who account for the majority of expenditure. Regular meetings are held to manage performance, encourage sustainable business activity and to identify and deliver continuous improvement opportunities for reducing costs further while improving performance and service levels.

#### **Payments to suppliers**

It is the Company's payment policy for the year ending 31 March 2009 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 2008 represented 35 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.

## REPORT OF THE DIRECTORS (continued)

Significant work has been undertaken through the year to prepare for the Periodic Review (2010 – 2015) of the water industry's prices. South West Water published its 25 year view of future aims in December 2007. Its Strategic Direction Statement sets out its primary aims and focus, based on the themes of Pure Water, Pure Service and Pure Environment. The development of the Draft Business Plan, for submission by August 2008 has been a key activity, supported by extensive studies, analysis and plan preparation of the many sub components of a price review.

Key dates for the current Periodic Review are

Date	Activity
April 2008	Ofwat published information requirements
April - May 2008	Companies' draft water resources plans published for consultation
August 2008	Submit and publish draft business plans
August 2008 - January 2009	Public consultation on draft business plans
December 2008	Ofwat publishes draft baseline, outputs package and 'menu'
January 2009	Ofwat issues final business plan reporting requirements
April 2009	Submit and publish final business plans
July 2009	Ofwat publishes draft determinations for comment
July - August 2009	Companies publish final water resources plans
November 2009	Ofwat publishes final determinations
January 2010	Decisions made by companies on determinations
April 2010	New price limits take effect for period 2010 to 2015

### DONATIONS

During the year, charitable donations amounting to £2,000 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 6.

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.

Richard Hughes retired on 31 August 2007. Susan Davy was appointed as Finance Director on 31 August 2007.

### PARENT COMPANY

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

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

### **STATEMENT OF DIRECTORS' RESPONSIBILITIES**

The Directors are responsible for preparing the Annual Report, the Directors' remuneration report and the financial statements in accordance with applicable law and regulations

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the financial statements in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. The financial statements are required by law to give a true and fair view of the state of affairs of the company and of the profit or loss of the company for the year.

In preparing these financial statements the Directors are required to

- select suitable accounting policies and then apply them consistently
- make judgements and estimates that are reasonable and prudent
- state that the financial statements comply with IFRS as adopted by the European Union

The Directors confirm that they have complied with the above requirements in preparing the financial statements. The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the financial statements and the Directors' remuneration report comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

### **STATEMENT AS TO DISCLOSURE OF INFORMATION TO AUDITORS**

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

### **AUDITORS**

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

### **ANNUAL GENERAL MEETING**

The nineteenth annual general meeting will be held at Peninsula House, Rydon Lane, Exeter on 22 July 2008 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 2008 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 only Chief Executives Review, Directors, Registered Office and Auditors, Report of Directors and Notice of Meeting. 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 2008 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

27 June 2008

## Income statement for the year ended 31 March 2008

	Notes	2008 £m	2007 £m
<b>Revenue</b>	5	421.3	381.8
<b>Operating costs</b>	6		
Manpower costs (excluding restructuring costs)		(34.8)	(34.0)
Raw materials and consumables used		(14.0)	(14.2)
Other operating expenses		(102.4)	(99.0)
Depreciation		(85.0)	(77.7)
Restructuring costs		(4.0)	(0.3)
<b>Operating profit</b>		<b>181.1</b>	<b>156.6</b>
Interest payable and similar charges	7	(94.2)	(79.8)
Interest receivable	7	29.3	21.6
<b>Profit before tax</b>		<b>116.2</b>	<b>98.4</b>
Tax on ordinary activities	8	(10.6)	(26.3)
<b>Profit for the year</b>		<b>105.6</b>	<b>72.1</b>
Profit attributable to equity shareholders		<b>105.6</b>	<b>72.1</b>

All operating activities are continuing activities

## Statement of recognised income and expense for the year ended 31 March 2008

	Notes	2008 £m	2007 £m
<b>Profit for the year</b>		<b>105.6</b>	<b>72.1</b>
Actuarial gains/(losses) on defined benefit schemes	24	3.9	(1.2)
Cash flow hedges net fair value (losses)/gains		(11.6)	14.7
Tax on items taken directly to or transferred from equity		(0.9)	0.4
<b>Net (losses)/gains not recognised directly in income statement</b>	29	<b>(8.6)</b>	<b>13.9</b>
<b>Total recognised income for the year</b>		<b>97.0</b>	<b>86.0</b>

The notes on pages 25 to 61 form part of these financial statements

## Balance sheet at 31 March 2008

	Notes	2008 £m	2007 £m
<b>Assets</b>			
<b>Non-current assets</b>			
Property, plant and equipment	12	2,323.8	2,243.5
Investment in subsidiary undertakings	15	3.3	3.3
Investment in joint venture	15	0.1	0.1
Trade and other receivables	14	0.8	0.7
		<u>2,328.0</u>	<u>2,247.6</u>
<b>Current assets</b>			
Inventories	16	4.1	4.0
Trade and other receivables	17	77.5	67.9
Derivative financial instruments	18	3.5	14.3
Cash and cash deposits	19	242.3	118.8
		<u>327.4</u>	<u>205.0</u>
<b>Liabilities</b>			
<b>Current liabilities</b>			
Borrowings	22	(84.9)	(74.1)
Derivative financial instruments	18	(0.5)	-
Trade and other payables	20	(94.7)	(88.5)
Current tax liabilities	21	(26.8)	(15.0)
Provisions for liabilities and charges	26	(1.5)	-
		<u>(208.4)</u>	<u>(177.6)</u>
<b>Net current assets</b>		<u>119.0</u>	<u>27.4</u>
<b>Non-current liabilities</b>			
Borrowings	22	(1,629.4)	(1,465.4)
Other non-current liabilities	23	(1.8)	(2.0)
Retirement benefit obligations	24	(21.7)	(34.5)
Deferred tax liabilities	25	(300.0)	(307.0)
		<u>(1,952.9)</u>	<u>(1,808.9)</u>
<b>Net assets</b>		<u>494.1</u>	<u>466.1</u>
<b>Shareholders' equity</b>			
Share capital	27	450.9	450.9
Retained earnings and other reserves	29	43.2	15.2
<b>Total shareholders' equity</b>		<u>494.1</u>	<u>466.1</u>

The notes on pages 25 to 61 form part of these financial statements

The financial statements on pages 22 to 61 were approved by the Board of Directors on 27 June 2008 and were signed on its behalf by

  
 C. Loughlin  
 Chief Executive

## Cash flow statement for the year ended 31 March 2008

	Notes	2008 £m	2007 £m
<b>Cash flows from operating activities</b>	30		
Cash generated from operations		255.4	226 0
Interest paid		(73.5)	(46 9)
Tax paid		(7.2)	(2 1)
Net cash generated from operating activities		<u>174.7</u>	<u>177 0</u>
<b>Cash flows from investing activities</b>			
Interest received		11.4	3 1
Receipt of grants and contributions		3.0	3 0
Purchase of property, plant and equipment		(163.7)	(194 5)
Proceeds from sale of property, plant and equipment		0.2	3 1
Net cash used in investing activities		<u>(149.1)</u>	<u>(185 3)</u>
<b>Cash flows from financing activities</b>			
Deposit of restricted funds		(5.8)	(4 1)
Net proceeds from new borrowing		206.7	100 0
Repayment of borrowings		(136.3)	(39 2)
Finance lease drawdowns on sale of property, plant and equipment		100.9	130 8
Finance lease principal repayments		(12.6)	(20 1)
Dividends paid		(68.7)	(75 0)
Parent company loans		-	(14 6)
Net cash received from financing activities		<u>84.2</u>	<u>77 8</u>
<b>Net increase in cash and cash deposits</b>		<b>109.8</b>	<b>69 5</b>
Cash and cash deposits at beginning of the year	19	100.8	31 3
<b>Cash and cash deposits at end of the year</b>	19	<u>210.6</u>	<u>100 8</u>

The notes on pages 25 to 61 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 6. The nature of the Company's operations and its principal activities are set out in the Directors' report on page 8.

These financial statements were approved by the Board of Directors on 27 June 2008.

### 2 Principal accounting policies

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

#### (a) Basis of preparation

These financial statements have been prepared under the historical cost convention in accordance with International Financial Reporting Standards (IFRS) and International Financial Reporting Interpretation Committee (IFRIC) interpretations, as adopted by the European Union, with those parts of the Companies Act 1985 applicable to companies reporting under IFRS. A summary of the principal accounting policies is set out below, together with an explanation where changes have been made to previous policies on the adoption of new accounting standards 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 8	"Operating segments "
IAS1	"Presentation of financial statements" (revised)
IAS23	"Borrowing costs" (revised)
IAS27	"Consolidated and separate financial statements" (revised)
IFRIC 12	"Service concession arrangements "
IFRIC 13	"Customer loyalty programmes "
IFRIC 14	"IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction"

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. The presentational impact of these standards and interpretations is being assessed.

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 Principal accounting policies (continued)

#### (b) Basis of consolidation

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.

#### (c) 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 mains water and waste water charges includes an estimation of the amount of unbilled charges at the period end based upon a defined methodology reflecting historical consumption, estimated demand trends and current tariffs.

Interest income is recognised on a time-proportion basis using the effective interest method.

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

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

Infrastructure assets 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.

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

Other assets are included at cost less accumulated depreciation.

## NOTES TO THE FINANCIAL STATEMENTS

### 2 Principal accounting policies (continued)

#### (d) Property, plant and equipment (continued)

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

#### (e) 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

#### (f) 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

#### (g) Inventories

Inventories and work in progress is stated at the lower of cost and net realisable value

#### (h) Cash and cash deposits

Cash and cash deposits comprise 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

## NOTES TO THE FINANCIAL STATEMENTS

### 2 Principal accounting policies (continued)

#### (i) 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.

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.

The full value of a hedging derivative is classified as a non-current asset or liability when the remaining hedged item is more than 12 months, and as a current asset or liability when the remaining maturity of the hedged item is less than 12 months.

Derivative instruments that do not qualify for hedge accounting are classified as a current asset or liability with any change in fair value recognised immediately in the income statement.

##### 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.

## NOTES TO THE FINANCIAL STATEMENTS

### 2 Principal accounting policies (continued)

#### iv) *Trade payables*

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

#### (j) **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.

#### (k) **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.

#### (l) **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 Directors' best estimates. The projected unit credit method is employed and liabilities 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 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.

##### 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.

## NOTES TO THE FINANCIAL STATEMENTS

### 2 Principal accounting policies (continued)

#### (m) 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

#### (a) Financial risk factors

The Company's activities expose it to a variety of financial risks, market risk (interest rate risk), liquidity risk and credit risk. 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) Market 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 64% of net borrowings were at fixed rates and 21% index-linked. The Company uses a combination of fixed rate and index-linked borrowings and fixed rate interest swaps as cash flow hedges of future variable interest payments to achieve this policy. 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.

The interest rate for index-linked debt is based upon an RPI measure which is also used in determining the amount of income from customers.

At 31 March 2008, if interest rates on net borrowings at that date had been 0.5% higher/lower with all other variables held constant, post-tax profit for the year would have been £0.9m (2007 £1.1m).

## 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.

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

Contractual undiscounted cash flows were

<b>31 March 2008</b>					
	Due within 1 year £m	Due between 1 and 2 years £m	Due between 2 and 5 years £m	Over 5 years £m	Total £m
Non-derivative financial liabilities					
Borrowings excluding finance lease	14.1	14.1	156.3	331.4	515.9
Liabilities					
Interest payments on borrowing	42.3	40.0	43.6	527.2	653.1
Finance lease liabilities	69.8	143.0	159.8	1,977.9	2,350.5
Derivative financial liabilities					
Derivative contracts – net receipts	3.5	-	-	-	3.5
<b>31 March 2007</b>					
	Due Within 1 year £m	Due between 1 and 2 years £m	Due between 2 and 5 years £m	Over 5 years £m	Total £m
Non-derivative financial liabilities					
Borrowings excluding finance lease	16.3	54.1	206.3	145.5	422.2
Liabilities					
Interest payments on borrowing	18.4	15.8	33.5	27.2	94.9
Finance lease liabilities	50.8	113.8	125.6	1,693.4	1,983.6
Derivative financial liabilities					
Derivative contracts – net receipts	6.0	9.9	6.1	-	22.0

## NOTES TO THE FINANCIAL STATEMENTS

### 3 Financial risk management (continued)

#### iii) Credit risk

Credit risk arises from cash and cash deposits, derivative financial instruments and deposits with bank and financial institutions, as well as exposure to customers, including outstanding receivables. Further information on the credit risk relating to trade receivables is given in note 17.

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.

#### (b) Capital risk management

The Company's objectives when managing capital are to safeguard the Company's ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders and to maintain an optimal capital structure to reduce the cost of capital.

Consistent with the industry peer group, the Company monitors capital on the basis of the gearing ratio. This ratio is calculated as net borrowings divided by total capital. Net debt is calculated as total borrowings (including current and non-current borrowings as shown in the consolidated balance sheet) less cash and cash deposits. Total capital is calculated as equity as shown in the balance sheet plus net borrowings.

The gearing ratios at 31 March 2008 and 2007 were as follows:

	<b>2008</b>	2007
	<b>£m</b>	£m
Net borrowings (note 31)	1,455.2	1,406.1
Total equity	494.1	466.1
Total capital	<u>1,949.3</u>	<u>1,872.2</u>
Gearing ratio	<u>75%</u>	<u>75%</u>

The Company is also monitored by the ratio of its debt to Regulated Capital Value in line with guidance from the water industry regulator Ofwat.

	<b>2008</b>	2007
	<b>£m</b>	£m
Regulatory Capital Value	2,408.0	2,265.0
Net borrowings	<u>1,455.2</u>	<u>1,406.1</u>
Debt / Regulatory Capital Value	<u>60%</u>	<u>62%</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 3 Financial risk management (continued)

#### (c) Determination of fair values

The fair value of financial instruments traded in active markets (such as trading and available-for-sale securities) is based on quoted market prices at the balance sheet date. The quoted market price used for financial assets held by the Company is the current bid price.

The fair value of financial instruments that are not traded in an active market (for example, over-the-counter derivatives) is determined by using valuation techniques. The Company uses a variety of methods and makes assumptions that are based on market conditions existing at each balance sheet date. Quoted market prices or dealer quotes for similar instruments are used for long-term debt. Other techniques, such as estimated discounted cash flows, are used to determine fair value for the remaining financial instruments. The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows.

The carrying value less impairment provision of trade receivables and payables are assumed to approximate their fair values. The fair value of financial liabilities for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate that is available to the Company for similar financial instruments.

### 4 Critical accounting judgements and estimates

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.

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

## NOTES TO THE FINANCIAL STATEMENTS

### 4 Critical accounting judgements and estimates (Continued)

#### *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 2008 was £2,323.8m. In the year ended 31 March 2008 additions to property, plant and equipment totalled £169.6m and the depreciation charge was £86.3m. 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*

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

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 2008 current trade receivables were £53.5m.

### 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	<b>Operating costs</b>	<b>2008</b> <b>£m</b>	<b>2007</b> <b>£m</b>
	Manpower costs (note 10)	<u>34.8</u>	<u>34 0</u>
	Raw materials and consumables	<u>14.0</u>	<u>14 2</u>
	<b>Other operating expenses include</b>		
	Loss / (profit) on disposal of property, plant and equipment	0.1	(2 5)
	Operating lease rentals payable		
	- Plant and machinery	0.6	0 7
	- Property	1.5	1 4
	Research and development expenditure	0.2	0 1
	Trade receivables impairment	<u>5.7</u>	<u>5 4</u>
	Depreciation of property, plant and equipment		
	- Owned assets	59.4	57 5
	- Under finance leases	<u>25.6</u>	<u>20 2</u>
		<u>85.0</u>	<u>77 7</u>
	Fees payable to the Company's auditors in the year were as follows		
		<b>2008</b> <b>£000</b>	<b>2007</b> <b>£000</b>
	Audit of the Company's accounts	92	120
	Audit-related regulatory reporting	28	45
	Other services	-	3
		<u>133</u>	<u>168</u>
	Expenses reimbursed to the auditors in relation to the audit of the Company were £13,000 (2007 £14,000)		
7	<b>Net finance costs</b>	<b>2008</b> <b>£m</b>	<b>2007</b> <b>£m</b>
	<b>Finance Costs</b>		
	Intercompany interest	(11.1)	(3 2)
	Bank borrowings and overdrafts	(14.6)	(19 8)
	Interest element of finance lease rentals	(51.9)	(41 5)
	Other finance costs	(1.3)	(0 2)
	Interest cost on retirement benefit obligations	<u>(15.3)</u>	<u>(15 1)</u>
		<u>(94.2)</u>	<u>(79 8)</u>
	<b>Finance Income</b>		
	Interest receivable	11.1	2 7
	Intercompany interest	0.8	0 7
	Expected return on pension scheme assets	<u>17.4</u>	<u>18 2</u>
		<u>29.3</u>	<u>21 6</u>
	<b>Net finance costs</b>	<u>(64.9)</u>	<u>(58 2)</u>

## NOTES TO THE FINANCIAL STATEMENTS

8 Taxation	2008 £m	2007 £m
<b>Analysis of charge in year</b>		
Current tax	18.5	15.2
Deferred tax (note 25)	12.6	11.1
Deferred tax effect of change in rate of corporation tax	(20.5)	-
	<u>10.6</u>	<u>26.3</u>

UK Corporation tax is calculated at 30% (2007 30%) of the estimated assessable profit for the year. The deferred tax charge has been reduced by a non-recurring credit of £20.5m reflecting the reduction in the rate of UK corporation tax from 30% to 28% effective 1 April 2008. 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.

	2008 £m	2007 £m
Profit before tax	<u>116.2</u>	<u>98.4</u>
Profit before tax multiplied by standard rate of corporation tax in the UK of 30% (2007 30%)	34.9	29.5
Effects of		
Expenses not deductible for tax purposes	0.6	0.2
Sale of assets and finance leasing	-	(3.8)
Other	(0.9)	(0.1)
Adjustments to tax charge in respect of prior year	(2.9)	0.5
Effect on deferred tax of change in corporation tax rate	(21.1)	-
Tax charge for year	<u>10.6</u>	<u>26.3</u>

The average applicable tax rate for the year was 9% (2007 27%).

In addition to the amount credited to the income statement, a deferred tax charge relating to actuarial gains on defined benefit schemes of £1.1m (2007 credit on actuarial losses £0.4m) has been charged directly to equity. A deferred tax credit relating to share-based payments of £0.2m (2007 nil) has been credited to equity.

## NOTES TO THE FINANCIAL STATEMENTS

9	<b>Dividends</b>	<b>2008</b>	<b>2007</b>
		<b>£m</b>	<b>£m</b>
	Amounts recognised as distributions to equity holders in the year		
	Base dividend in respect of 2006/07 paid 19 October 2007	<b>45.7</b>	20 0
	Outperformance dividend paid 15 January 2008	<b>23.0</b>	-
	Special refinancing dividend	-	55 0
		<u><b>68.7</b></u>	<u>75 0</u>

### 10 Employment costs

The average number of persons (including Directors) employed by the Company was 1,276 (2007 1,301)

		<b>2008</b>	<b>2007</b>
		<b>£m</b>	<b>£m</b>
	Employment costs comprise		
	Wages and salaries	<b>34.6</b>	32 2
	Social security costs	<b>2.4</b>	2 3
	Pension costs	<b>10.0</b>	8 3
	Share-based payments	<b>0.8</b>	1 1
	Total employment costs	<u><b>47.8</b></u>	<u>43 9</u>
	Charged as follows		
	Manpower costs	<b>34.8</b>	34 0
	Capital schemes	<b>10.2</b>	9 9
	Restructuring provision	<b>2.8</b>	-
	Total employment costs	<u><b>47.8</b></u>	<u>43 9</u>

Details of Directors emoluments are set out in note 11. There are no personnel other than Directors, who as key management exercise authority and responsibility for planning, directing and controlling the activities of the Company.

## NOTES TO THE FINANCIAL STATEMENTS

11	<b>Directors' emoluments</b>	<b>2008</b>	<b>2007</b>
		<b>£000</b>	<b>£000</b>
	Total emoluments of the Directors of the Company		
	Salary	<b>555</b>	508
	Performance related	<b>169</b>	132
	Share-based payments	<b>213</b>	328
	Other emoluments	<b>147</b>	128
	<b>Total emoluments</b>	<b><u>1,084</u></b>	<b><u>1,096</u></b>

The cost of share-based payments represents the amount charged to the income statement, as described in note 28

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, in respect of another director, relocation costs

The emoluments of the highest paid Director were £397,000 (2007 £261,000)

At 31 March 2008 retirement benefits were accruing to 3 Directors (2007 3 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

### 12 Property, plant & equipment

	Land and buildings	Infrastructure assets	Operational properties	Fixed and mobile plant, vehicles and computers	Construction in progress	Total
	£m	£m	£m	£m	£m	£m
<b>Cost :</b>						
At 1 April 2006	13.9	1,096.4	565.4	832.0	99.8	2,607.5
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>
Additions	1.1	50.0	1.5	35.5	81.5	169.6
Grants & contributions	-	(2.7)	-	-	-	(2.7)
Disposals	(0.1)	(0.7)	-	(2.7)	-	(3.5)
Transfers/reclassifications	1.0	17.3	13.1	34.9	(66.3)	-
<b>At 31 March 2008</b>	<b>17.6</b>	<b>1,249.1</b>	<b>593.6</b>	<b>979.7</b>	<b>107.5</b>	<b>2,947.5</b>
<b>Depreciation :</b>						
At 1 April 2006	3.8	13.2	123.7	323.7	-	464.4
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>-</b>	<b>540.6</b>
Charge for year	0.3	16.9	10.6	58.5	-	86.3
Disposals	-	(0.7)	-	(2.5)	-	(3.2)
<b>At 31 March 2008</b>	<b>4.0</b>	<b>43.9</b>	<b>145.2</b>	<b>430.6</b>	<b>-</b>	<b>623.7</b>
<b>Net book value :</b>						
<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>
<b>At 31 March 2008</b>	<b>13.6</b>	<b>1,205.2</b>	<b>448.4</b>	<b>549.1</b>	<b>107.5</b>	<b>2,323.8</b>

Out of the total depreciation charge for the Company of £86.3m (2007 £79.3m), the sum of £1.3m (2007 £1.6m) has been charged to capital projects, and £85.0m (2007 £77.7m) against profits.

## NOTES TO THE FINANCIAL STATEMENTS

### 12 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
<b>Cost</b>						
At 31 March 2007	-	271.3	387.3	285.5	63.7	1,007.8
<b>At 31 March 2008</b>	<b>-</b>	<b>324.0</b>	<b>432.3</b>	<b>303.9</b>	<b>48.0</b>	<b>1,108.2</b>
<b>Depreciation</b>						
At 31 March 2007	-	6.4	59.9	124.3	-	190.6
<b>At 31 March 2008</b>	<b>-</b>	<b>10.5</b>	<b>66.5</b>	<b>137.2</b>	<b>-</b>	<b>214.2</b>
<b>Net book amount</b>						
At 31 March 2007	-	264.9	327.4	161.2	63.7	817.2
<b>At 31 March 2008</b>	<b>-</b>	<b>313.5</b>	<b>365.8</b>	<b>166.7</b>	<b>48.0</b>	<b>894.0</b>

### 13 Financial instruments by category

The accounting policies for financial instruments have been applied to the line items as below

	Note	Fair value Derivatives used for hedging £m	Amortised cost Loans and receivables £m	Trade receivables and trade payables £m	Total £m
<b>31 March 2008</b>					
<b>Financial assets</b>					
Trade and other receivables	14 & 17	-	29.4	21.1	50.5
Derivative financial instruments	18	3.5	-	-	3.5
Cash and cash deposits	19	-	242.3	-	242.3
<b>Total</b>		<b>3.5</b>	<b>271.7</b>	<b>21.1</b>	<b>296.3</b>
<b>Financial liabilities</b>					
Borrowings	22	-	(1,714.3)	-	(1,714.3)
Derivative financial instruments	18	(0.5)	-	-	(0.5)
Trade and other payables	20	-	(33.3)	(61.4)	(94.7)
<b>Total</b>		<b>(0.5)</b>	<b>(1,747.6)</b>	<b>(61.4)</b>	<b>(1,809.5)</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 13 Financial instruments by category (continued)

	Note	Fair value Derivatives used for hedging £m	Amortised cost Loans and receivables £m	Trade receivables and trade payables £m	Total £m
<b>31 March 2007</b>					
<b>Financial assets</b>					
Trade and other receivables	14 & 17	-	25 1	17 1	42 2
Derivative financial instruments	18	14 3	-	-	14 3
Cash and cash deposits	19	-	118 8	-	118 8
<b>Total</b>		<b>14 3</b>	<b>143 9</b>	<b>17 1</b>	<b>175 3</b>
<b>Financial liabilities</b>					
Borrowings	22	-	(1,539 5)	-	(1,539 5)
Trade and other payables	20	-	(30 8)	(57 7)	(88 5)
<b>Total</b>		<b>-</b>	<b>(1,570 3)</b>	<b>(57 7)</b>	<b>(1,628 0)</b>

14	<b>Trade and other receivables non-current</b>	<b>2008 £m</b>	<b>2007 £m</b>
	Amounts owed by subsidiary company	<b>0.8</b>	<b>0 7</b>
15	<b>Investments</b>	<b>2008 £m</b>	<b>2007 £m</b>
	Subsidiary undertakings	<b>3.3</b>	<b>3 3</b>
	Joint venture	<b>0.1</b>	<b>0 1</b>

The Company has four wholly-owned subsidiaries, Peninsula Properties (Exeter) Limited, Peninsula Leasing Limited, South West Water Finance Plc and Haldon Collection Limited. All companies are incorporated, registered and operate 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 (b).

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>2008</b>	<b>2007</b>
		<b>£m</b>	<b>£m</b>
	Raw materials and consumables	<u>4.1</u>	<u>4.0</u>
17	<b>Trade and other receivables – current</b>	<b>2008</b>	<b>2007</b>
		<b>£m</b>	<b>£m</b>
	Trade receivables	53.5	47.4
	Less provision for impairment of receivables	<u>(32.4)</u>	<u>(30.3)</u>
	Net trade receivables	21.1	17.1
	Amounts owed by subsidiary companies	0.7	1.0
	Amounts owed by fellow subsidiary companies	6.5	6.1
	Amounts owed by joint venture	2.1	0.9
	Amount owed by parent undertaking	16.5	14.7
	Other receivables	2.8	1.7
	Other prepayments and accrued income	27.8	26.4
		<u>77.5</u>	<u>67.9</u>

The Directors consider that the carrying amount of trade and other receivables approximates to their fair values. Trade receivables, the provision for impairment and accrued income for 2007 have been restated to exclude amounts shown as a reduction to revenues and provided against accrued income in previous years.

There is no concentration of credit risk in trade receivables. The Company has a large number of customers who are dispersed and there is no significant loss on trade receivables that has not been provided for.

The company has created IAS 39 portfolio provisions, but it cannot identify which receivables specifically are the ones impaired. It is company policy to consider a receivable in a portfolio to which an impairment has been allocated on a collective basis as not being impaired for the purposes of IFRS 7 disclosures until the loss can be specifically identified with the receivable.

The ageing of gross trade receivables was

	<b>2008</b>	<b>2007</b>
	<b>£m</b>	<b>£m</b>
Past due 0 – 30 days	7.6	6.6
Past due 31 – 120 days	8.3	6.6
Past due more than 120 days	<u>47.4</u>	<u>38.3</u>

The Company has a duty under legislation to continue to provide domestic customers with services regardless of payment. It specifically reviews separate categories of debt to identify an appropriate provision for impairment.

## NOTES TO THE FINANCIAL STATEMENTS

### 17. Trade and other receivables – current (continued)

The movement in the allowance for impairment in respect of trade receivables was

	2008 £m	2007 £m
At April 1	30.3	27.6
Provision for receivables impairment	5.7	5.4
Receivables written-off during the year as uncollectible	<u>(3.6)</u>	<u>(2.7)</u>
	<u>32.4</u>	<u>30.3</u>

### 18. Derivative financial instruments

Interest rate swaps – cash flow hedges

	2008 £m	2007 £m
Assets	<u>3.5</u>	<u>14.3</u>
Liabilities	<u>(0.5)</u>	<u>-</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 2008 64% of net borrowings was at fixed rate (2007 66%)

At 31 March 2008 interest rate swaps to hedge financial liabilities with a notional principal value of £584.0m existed, with a weighted average maturity of 3.0 years (2007 £584.0m, with 3.1 years) to swap from floating to fixed rate. The weighted average interest rate of the swaps was 4.9% (2007 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.

### 19. Cash and cash deposits

	2008 £m	2007 £m
Cash at bank and in hand	0.8	0.3
Overnight deposits	141.1	54.2
Other short-term deposits	90.3	60.2
Other deposits	10.1	4.1
	<u>242.3</u>	<u>118.8</u>

The effective interest rate on short-term deposits was 5.6% (2007 5.3%) and these deposits have an average maturity of 9 days.

Other deposits include £10.1m (2007 £4.1m) of restricted funds to settle long-term liabilities (note 22).

## NOTES TO THE FINANCIAL STATEMENTS

### 19 Cash and cash deposits (continued)

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

	2008 £m	2007 £m
Cash and cash deposits as above	242.3	118.8
Overdrafts (note 22)	<u>(21.6)</u>	<u>(13.9)</u>
	220.7	104.9
Less deposits with a maturity of three months or more	<u>(10.1)</u>	<u>(4.1)</u>
	<u>210.6</u>	<u>100.8</u>

### 20 Trade and other payables – current

	2008 £m	2007 £m
Trade payables	61.4	57.7
Amounts owed to parent undertaking	-	0.1
Amounts owed to subsidiary companies	3.4	1.6
Amounts owed to fellow subsidiaries	0.1	0.2
Amounts owed to joint venture	0.2	0.2
Other tax and social security	7.0	8.3
Other payables	2.3	3.4
Accruals	20.1	17.0
Deferred income	0.2	-
	<u>94.7</u>	<u>88.5</u>

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

### 21 Current tax liabilities

	2008 £m	2007 £m
Corporation tax	<u>26.8</u>	<u>15.0</u>

## NOTES TO THE FINANCIAL STATEMENTS

22	Borrowings	2008 £m	2007 £m
	<b>Current</b>		
	Bank overdrafts	21.6	13.9
	European Investment Bank	14.1	16.3
		<u>35.7</u>	<u>30.2</u>
	Obligations under finance leases	49.2	43.9
		<u>84.9</u>	<u>74.1</u>
	<b>Non-current</b>		
	European Investment Bank	201.8	215.9
	Bank loans	-	120.0
	Loan from subsidiary company	311.7	100.0
		<u>513.5</u>	<u>435.9</u>
	Obligations under finance leases	1,115.9	1,029.5
		<u>1,629.4</u>	<u>1,465.4</u>
	<b>Total borrowings</b>	<u>1,714.3</u>	<u>1,539.5</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

	2008		2007	
	Book value £m	Fair value £m	Book value £m	Fair Value £m
European Investment Bank	201.8	197.4	215.9	210.9
Bank loans	-	-	120.0	120.0
Loan from subsidiary company	311.7	280.7	100.0	99.6
	<u>513.5</u>	<u>478.1</u>	<u>435.9</u>	<u>430.5</u>
Obligations under finance leases	1,115.9	984.2	1,029.5	917.9
	<u>1,629.4</u>	<u>1,462.3</u>	<u>1,465.4</u>	<u>1,348.4</u>

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

## NOTES TO THE FINANCIAL STATEMENTS

### 22 Borrowings (continued)

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

	2008 £m	2007 £m
6 months or less	797.4	871.9
6 – 12 months	488.4	448.5
1 – 5 years	216.8	219.1
Over 5 years	211.7	-
	<u>1,714.3</u>	<u>1,539.5</u>

The maturity of non-current borrowings was

	2008 £m	2007 £m
Between 1 and 2 years	54.9	90.9
Between 2 and 5 years	250.6	310.3
Over 5 years	1,323.9	1,064.2
	<u>1,629.4</u>	<u>1,465.4</u>

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

	2008 %	2007 %
Bank overdrafts	6.3	6.3
European Investment Bank	6.0	5.6
Bank loans	n/a	5.9
Finance leases	4.6	4.4
Loan from subsidiary company	5.0	4.1

Finance lease liabilities – minimum lease payments

	2008 £m	2007 £m
Within one year	70.5	59.1
In the second to fifth years inclusive	303.3	266.0
After five years	1,977.9	1,866.6
	<u>2,351.7</u>	<u>2,191.7</u>
Less future finance charges	<u>(1,186.6)</u>	<u>(1,118.4)</u>
	<u>1,165.1</u>	<u>1,073.3</u>

Included above are accrued finance charges arising on obligations under finance leases totalling £129.8m (2007 £126.4m), of which £39.5m (2007 £36.5m) is repayable within one year

Included above is £21.7m (2007 £27.8m) due to Peninsula Leasing Limited, a subsidiary company, under finance lease agreements of which £7.6m (2007 £6.4m) is repayable within one year

## NOTES TO THE FINANCIAL STATEMENTS

### 22 Borrowings (continued)

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 2006/07 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 £10 1m at 31 March 2008 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.

The Company has undrawn committed borrowing facilities

	2008 £m	2007 £m
Floating rate		
Expiring within one year	55.0	120 0
Expiring after one year	80.0	45 0
	<u>135.0</u>	<u>165 0</u>

In addition, the Company has short-term uncommitted bank facilities of £80 0m (2007 £90 0m)

### 23 Other non-current liabilities

	2008 £m	2007 £m
Other creditors	<u>1.8</u>	<u>2 0</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

	2008 %	2007 %
Expected return on scheme assets	7.0	6 9
Rate of increase in pensionable pay	4.4	4 0
Rate of increase for present and future pensions	3.4	3 0
Rate used to discount schemes' liabilities	6.9	5 4
Inflation	3.4	3 0

## NOTES TO THE FINANCIAL STATEMENTS

### 24 Retirement benefit obligations (continued)

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

The amounts recognised in the income statement were

	2008 £m	2007 £m
Current service cost	(8.7)	(8.7)
Past service cost	(1.2)	(0.8)
Total included within operating costs	<u>(9.9)</u>	<u>(9.5)</u>
Expected return on pension schemes' assets	17.4	18.2
Interest cost on retirement benefit obligations	(15.3)	(15.1)
Total included within net finance costs	<u>2.1</u>	<u>3.1</u>
Total charge	<u>(7.8)</u>	<u>(6.4)</u>

The actual return on schemes' assets was a decrease of £34.1m (2007 return of £21.4m)

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

	2008 £m	2007 £m
Actuarial gains / (losses) recognised in the year (net of tax)	<u>3.9</u>	<u>(1.2)</u>

The amounts recognised in the balance sheet were

	2008 £m	2007 £m
Fair value of scheme's assets	255.4	285.5
Present value of defined benefit obligations	(277.1)	(320.0)
Net liability recognised in the balance sheet	<u>(21.7)</u>	<u>(34.5)</u>

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

	Expected Return %	2008 Value £m	Fund %	Expected Return %	2007 Value £m	Fund %
Equities	8.0	152.1	60	8.0	160.4	56
Property / currency	7.6	11.6	4	7.8	30.1	11
Bonds	4.6	91.6	36	4.7	94.6	33
Other	5.9	0.1	-	5.0	0.4	-
		<u>255.4</u>	<u>100</u>		<u>285.5</u>	<u>100</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 24 Retirement benefit obligations (continued)

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.

In conjunction with the trustees and investment advisers, the Pennon Group restructured its portfolio of defined benefit pension investments during 2006/07 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 60%) and international markets (c 40%), excluding emerging markets.

Movements in the balance sheet liability were

	2008	2007
	£m	£m
At 1 April 2007	(34.5)	(35.0)
Income statement	(7.8)	(6.4)
Statement of recognised income and expenditure	3.9	(1.2)
Regular contributions	1.3	1.7
Prepayment of contributions	15.4	6.4
At 31 March 2008	<u>(21.7)</u>	<u>(34.5)</u>

Movements in the fair value of scheme's assets were

	2008	2007
	£m	£m
At 1 April 2007	285.5	266.7
Expected return on schemes' assets	17.4	18.2
Actuarial (losses) / gains	(53.6)	3.2
Members' contributions	0.3	0.2
Benefits paid	(10.9)	(10.9)
Company regular contributions	1.3	1.7
Prepayment of Company regular contributions	15.4	6.4
At 31 March 2008	<u>255.4</u>	<u>285.5</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 24 Retirement benefit obligations (continued)

Movements in the present value of defined benefit obligations were:

	2008 £m	2007 £m
At 1 April 2007	(320.0)	(301.7)
Service costs	(9.9)	(9.5)
Interest cost	(15.3)	(15.1)
Members' contributions	(0.3)	(0.2)
Benefits paid	10.9	10.9
Actuarial gains and losses	57.5	(4.4)
At 31 March 2008	<u>(277.1)</u>	<u>(320.0)</u>

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 two years.

	2008 £m	2007 £m	2006 £m
Fair value of scheme's assets	255.4	285.5	266.7
Present value of defined benefit obligations	<u>(277.1)</u>	<u>(320.0)</u>	<u>(301.7)</u>
Net liability recognised	<u>(21.7)</u>	<u>(34.5)</u>	<u>(35.0)</u>
Experience (losses) / gains on scheme's assets			
Amount (£m)	(53.6)	3.2	33.7
Percentage of scheme's assets	(21.0)%	1.1%	12.6%
Experience losses on defined benefit obligations			
Amount (£m)	(5.8)	(4.4)	(32.2)
Percentage of defined benefit obligations	(2.09)%	(1.4)%	(10.7)%

Pennon Group has recently completed the triennial actuarial valuation of its defined benefit schemes as at 1 April 2007 which has resulted in higher future service and deficit recovery contributions. The Company's current service cost during the year was 21.7% of pensionable earnings (2007 21.7%). The Company's existing defined benefit schemes have been closed to new entrants from 1 April 2008.

The Company has agreed with the trustees that it will aim to eliminate the actuarially calculated funding deficit of circa £30m at 31 March 2007 over a 10 year period.

The Pennon Group monitors funding levels on an annual basis and the Company made a contribution prepayment of £15.4m during the year (2007 £6.4m). As a result of this prepayment no further Company regular contributions are expected to be paid to the scheme during the year ended 31 March 2009.

## NOTES TO THE FINANCIAL STATEMENTS

### 25 Deferred tax liabilities

Deferred tax is calculated in full on temporary differences under the liability method using a tax rate of 28% (2007 30%)

The movements on the deferred tax account were

	2008 £m	2007 £m
At 1 April	307.0	296.3
Effect of change in corporation tax rate	(20.5)	-
Charged to the income statement	12.6	11.1
Charged / (credited) to equity	0.9	(0.4)
At 31 March	300.0	307.0

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

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 2006	314.3	5.1	319.4
Charged to the income statement	3.1	4.9	8.0
At 31 March 2007	317.4	10.0	327.4
Effect of change in corporation tax rate	(21.2)	(0.7)	(21.9)
(Credited) / charged to the income statement	(0.7)	6.2	5.5
<b>At 31 March 2008</b>	<b>295.5</b>	<b>15.5</b>	<b>311.0</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 25 Deferred tax liabilities (continued)

#### Deferred tax assets

	Provisions £m	Retirement benefit obligations £m	Other £m	Total £m
At 1 April 2006	(4.4)	(10.3)	(8.4)	(23.1)
Charged / (credited) to the income statement	0.6	0.4	2.1	3.1
Credited to equity	-	(0.4)	-	(0.4)
At 31 March 2007	(3.8)	(10.3)	(6.3)	(20.4)
Effect of change in corporation tax rate	0.3	0.7	0.4	1.4
Charged to the income statement	1.9	2.5	2.7	7.1
Charged / (credited) to equity	-	1.1	(0.2)	0.9
<b>At 31 March 2008</b>	<b>(1.6)</b>	<b>(6.0)</b>	<b>(3.4)</b>	<b>(11.0)</b>

#### Net deferred tax liability

At 31 March 2007	<u>307.0</u>
<b>At 31 March 2008</b>	<u><b>300.0</b></u>

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

	2008 £m	2007 £m
Actuarial (losses) / gains on defined benefit schemes	(1.1)	0.4
Share-based payments (note 29)	0.2	-
	<u>(0.9)</u>	<u>0.4</u>

### 26 Provisions for liabilities and charges

Restructuring	2008 £m	2007 £m
At 1 April	-	1.3
Charged / (credited) to the income statement	4.0	(0.2)
Utilised during year	(2.5)	(1.1)
<b>At 31 March</b>	<u><b>1.5</b></u>	<u><b>-</b></u>

The provisions are all current

## NOTES TO THE FINANCIAL STATEMENTS

### 27 Called-up share capital

	2008 £m	2007 £m
<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 equity settled share plans for the benefit of employees. Details of each plan are set out below.

#### i) Sharesave Scheme

An all-employee savings related plan is operated 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.

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	
		2008	2007
6 July 1999 275p	2002 – 2006	-	1
5 July 2000 154p	2003 – 2007	-	171
4 July 2001 163p	2004 – 2008	29	32
9 July 2002 189p	2005 – 2009	27	171
8 July 2003 177p	2006 – 2010	256	268
6 July 2004 200p	2007 – 2011	195	538
5 July 2005 270p	2008 – 2012	403	440
4 July 2006 358p	2009 – 2013	394	431
3 July 2007 522p	2010 - 2014	306	-
		<u>1610</u>	<u>2,052</u>

At 31 March 2008 there were 752 participants in the Sharesave Scheme (2007 721).

## NOTES TO THE FINANCIAL STATEMENTS

### 28 Employee share schemes (continued)

#### i) Sharesave Scheme (continued)

The number and weighted average exercise price of Sharesave options are

	2008		2007	
	Number of Ordinary shares (thousands)	Weighted average exercise price per share p	Number of Ordinary shares (thousands)	Weighted average exercise price per share p
At 1 April	2,052	240	2,547	198
Granted	332	522	444	358
Exercised	(606)	186	(871)	176
Expired	(168)	292	(68)	235
At 31 March	<u>1,610</u>	<u>313</u>	<u>2,052</u>	<u>240</u>

The weighted average price at the date of exercise of Sharesave options during the year was 606p (2007 477p). The options outstanding at 31 March 2008 had a weighted average exercise price of 313p (2007 240p) and a weighted average remaining contractual life of 1.9 years (2007 1.9 years).

The aggregate fair value of options granted during the year was £0.3m (2007 £0.3m), determined using the Black-Scholes valuation model. The significant inputs into the valuation model were

	2008	2007
Weighted average share price	409p	321p
Weighted average exercise price	327p	257p
Expected volatility	21.0%	22.3%
Expected life	4.3 years	4.2 years
Risk-free rate	4.7%	4.6%
Expected dividend yield	4.2%	4.6%

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.

## NOTES TO THE FINANCIAL STATEMENTS

### 28 Employee share schemes (continued)

#### ii) Restricted Share Plan (continued)

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

	2008		2007	
	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	563	360	618	287
Granted	-	-	145	499
Vested	(176)	270	(95)	195
Lapsed	(62)	350	(105)	270
At 31 March	<u>325</u>	<u>411</u>	<u>563</u>	<u>360</u>

The plan was replaced during the year by the Performance and Co-investment Plan

The awards outstanding at 31 March 2008 had a weighted average price of 411p (2007 360p) and a weighted average remaining contractual life of 1.1 years (2007 1.2 years). The Pennon Group Plc share price at the date of the awards ranged from 357p to 499p.

The aggregate fair value of awards granted during the year was £nil (2007 £0.4m), determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the awards were

	2008	2007
Weighted average share price	449p	346p
Expected volatility	20.9%	22.6%
Risk-free rate	4.8%	4.7%

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

#### iii) Performance and Co-investment Plan

The plan was approved by Pennon Group Plc shareholders at the Annual General Meeting in July 2007 and was introduced in September 2007. Executive Directors and senior management receive a conditional award of ordinary shares in the Company and are also required to hold a substantial personal holding in Pennon Group Plc shares. The eventual number of shares, if any, which vest is dependent upon the achievement of conditions of the plan over the restricted period, being not less than three years.

## NOTES TO THE FINANCIAL STATEMENTS

### 28 Employee share schemes (continued)

The number and exercise price of shares in the Performance and Co-investment Plan are

	2008	
	Number of Ordinary Shares (thousands)	Weighted Average price per Share p
At 1 April	-	-
Granted	108	557
At 31 March	<u>108</u>	<u>557</u>

The awards outstanding at 31 March 2008 had an exercise price of 557p and a remaining contractual life of 2.5 years. The aggregate fair value of awards granted during the year was £0.6 million, determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were

	2008
Share price	557p
Expected volatility	18.7%
Risk-free rate	5.3%

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

#### iv) 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

	2008		2007	
	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	165	349	225	269
Granted	51	600	62	486
Vested	(94)	345	(122)	271
At 31 March	122	457	165	349

The awards outstanding at 31 March 2008 had a weighted average price of 457p (2007 349p) and a weighted average remaining contractual life of 1.4 years (2007 1.4 years). The Company's share price at the date of the awards ranged from 328p to 600p.

## NOTES TO THE FINANCIAL STATEMENTS

### 28 Employee share schemes (continued)

The aggregate fair value of awards granted during the year was £0.3m (2007 £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.

### 29 Retained earnings and other reserves

	Hedging reserve	Retained earnings	Total
	£m	£m	£m
At 1 April 2006	(0.5)	3.9	3.4
Profit for the 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>
Profit for year	-	105.6	105.6
Other recognised income and expense for the year	(11.6)	3.0	(8.6)
Dividends paid	-	(68.7)	(68.7)
Adjustment in respect of share-based payments	-	0.5	0.5
Adjustment in respect of share options vesting	-	(0.8)	(0.8)
<b>At 31 March 2008</b>	<b>2.6</b>	<b>40.6</b>	<b>43.2</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

	2008 £m	2007 £m
<b>Continuing operations</b>		
Profit for the year	105.6	72.1
Adjustments for		
Employee share schemes	0.8	1.2
Deferred income released to profits	(0.2)	(0.2)
Loss / (Profit) on disposal of property, plant and equipment	0.1	(2.4)
Depreciation charge	85.0	77.7
Interest payable and similar charges	94.2	79.8
Interest receivable	(29.3)	(21.6)
Taxation	10.6	26.3
Changes in working capital		
(Increase) in inventories	(0.1)	-
(Increase) in trade and other receivables	(6.4)	(7.0)
Increase in trade and other payables	0.5	-
(Decrease) / increase in retirement benefit obligations	(6.9)	1.4
Increase / (Decrease) in provisions for liabilities and charges	1.5	(1.3)
Cash generated from operations	<u>255.4</u>	<u>226.0</u>

### 31 Net borrowings

	2008 £m	2007 £m
Cash and cash deposits	242.3	118.8
Loan to parent company	16.8	14.6
<i>Borrowings - current</i>		
Bank overdrafts	(21.6)	(13.9)
Other current borrowings	(14.1)	(16.3)
Finance lease obligations	(49.2)	(43.9)
<b>Total current borrowings</b>	<u>(84.9)</u>	<u>(74.1)</u>
<i>Borrowings - non current</i>		
Bank loans	-	(120.0)
Other non-current borrowings	(513.5)	(315.9)
Finance lease obligations	(1,115.9)	(1,029.5)
<b>Total non-current borrowings</b>	<u>(1,629.4)</u>	<u>(1,465.4)</u>
<b>Total net borrowings</b>	<u>(1,455.2)</u>	<u>(1,406.1)</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 32 Operating lease commitments – minimum lease payments

	2008 £m	2007 £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	19.5	20.1
	<u>25.8</u>	<u>26.4</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 26 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

	2008 £m	2007 £m
Guarantee of borrowings of subsidiary undertaking	<u>302.3</u>	<u>100.0</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

	2008 £m	2007 £m
Contracted but not provided	<u>74.1</u>	<u>67.0</u>

### 35 Related party transactions

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

<u>Parent company</u>	2008 £m	2007 £m
Purchase of goods and services		
Group expenses	3.9	3.7
Sale of goods and services		
Administrative services	0.5	0.5
Loan interest paid	-	-
Loan interest received	0.8	0.6
Dividends paid	68.7	75.0

## NOTES TO THE FINANCIAL STATEMENTS

### 35 Related party transactions (continued)

<u>Subsidiaries of the Company</u>	2008 £m	2007 £m
Purchase of goods and services		
Property consultancy	0.1	0.5
Payment for provision of finance		
Loan interest	11.1	3.2
Finance lease charges vehicles	0.1	0.1
Finance lease charges plant & machinery	1.9	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	0.6	0.7
Insurance premia	1.6	0.8
Sale of goods and services		
Tankered waste and trade effluent charges	0.5	0.3
<u>Joint venture</u>		
Purchase of goods and services		
Customer service and billing facilities	10.3	9.4
Sale of goods and services		
Administrative services	2.7	2.6
<b>Year end balances</b>		
Borrowings (note 22)		
Loan from subsidiary	311.7	100.0
Finance lease balances with subsidiary	21.7	27.8
Receivables (notes 14 and 17)		
Parent company	16.5	14.7
Subsidiaries	1.5	1.7
Fellow subsidiaries	6.5	6.1
Joint venture	2.1	0.9
Payables (note 20)		
Parent company	-	0.1
Subsidiaries	3.4	1.6
Fellow subsidiaries	0.1	0.2
Joint venture	0.2	0.2

## **NOTES TO THE FINANCIAL STATEMENTS**

### **36 Parent Company**

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