

SOUTH WEST WATER LIMITED

ANNUAL REPORT AND FINANCIAL STATEMENTS 2010



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

ANNUAL REPORT AND FINANCIAL STATEMENTS 2010

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CHIEF EXECUTIVE'S REVIEW

South West Water performed strongly this year, improving its customer service, delivering further operational efficiencies and achieving sound financial results. It has now successfully completed the 2005 – 2010 regulatory contract and has a solid platform in place for continued success during the next regulatory period (2010 – 2015).

The company continues to be led by its vision of 'Pure Water, Pure Service and Pure Environment'. Underpinning this vision is the strategy of striking the right balance between investing to improve our services, customer affordability and financeability.

In November 2009 Ofwat announced its Final Determination of the company's business plans and set price limits for the period 2010 - 2015. This confirmed average real price increases of 1.9% over the next five years.

Throughout the Periodic Review process, our focus was on safeguarding our many achievements of the last 20 years through investment where needed whilst delivering stable bills for our customers. Our future plans continue to reflect customer priorities but we have also challenged ourselves to deliver further cost efficiencies beyond those set by Ofwat.

Many of our key operational results and achievements over the last 12 months demonstrate the benefits of our 'Pure Water, Pure Service, Pure Environment' approach.

During 2009/10, the company delivered significant improvements in both operational and customer service performance across a range of key measures, which will provide a springboard for the challenges to come.

Pure Water

Tap water quality, as measured by Mean Zonal Compliance, is the Drinking Water Inspectorate's preferred method for water quality assessment. In 2009 we maintained the best ever compliance value of 99.98% (2008 99.98%).

Maintaining high quality levels was the target of our recently completed £220 million water mains renewal programme undertaken between 2005 and 2010. During the final year of the project, 104 kilometres of mains pipes were relined or replaced and all five DWI-approved programme milestones were successfully completed. The final milestone was achieved ahead of schedule.

Carrying out repairs on the network can cause the interruption of water supplies to customers. However, during 2009/10, there was a welcome improvement in this area with the number of properties experiencing unplanned interruptions falling to 514 properties (2008/09 1,407).

Despite the coldest winter for nearly 30 years causing a surge in burst pipe incidents for both our customers and network, we still beat our anti-leakage target of 84 Megalitres per day, and achieved a best ever performance of 82 MI/d.

We have now achieved or beaten our leakage targets every year since they were first introduced by Ofwat in 1999/2000. Our leakage rate remains among the lowest in the industry at 5.5 cubic metres per kilometre of mains per day.

CHIEF EXECUTIVE'S REVIEW (Continued)

This has also been our 13th consecutive year without water restrictions. To maintain this record, the company has put in place a comprehensive strategy to ensure a continued secure supply of water for the region.

During the year, work on two major new trunk mains serving South Devon and East Cornwall was completed, strengthening water supplies in each area for decades to come.

Park Lake on Bodmin Moor, the company's fifth biggest reservoir, is now operational while work has started on converting nearby Stannon Lake into the company's fourth biggest reservoir. These former china clay pits were purchased in 2006 as a cost-effective alternative to building new reservoirs.

Pure Service

Renewing its emphasis on excellent service has helped the company improve its performance for customers.

We are achieving year-on-year reductions in operational service contacts, with a 24% reduction in the last year, and reductions in repeat service contacts. Improvements to the handling of service contacts have helped reduce the number of complaints received.

Customer satisfaction with the way their contact with the company has been handled and the ease of contacting us has improved, resulting in a best ever performance of 4.53 out of a possible 5.0 maximum.

However, there is still room for improvement and we want to ensure that we have systems in place which ensure continuous advances in our customer service.

This will include extending a range of measures to assist those customers in genuine financial difficulty as a result of the recession while still actively pursuing those who can pay their bills but do not.

In particular, we will be continuing to support our ground-breaking WaterCare programme, which has assisted over 7,000 households since its introduction in 2007.

Through WaterCare, customers are advised on how to better manage their water use and household budgets – including claiming all the benefits to which they are entitled. The free installation of water-saving devices has proved popular with customers and both they and the company have benefited from moving them on to affordable and regular payments plans.

A number of the customers on this programme are now paying on average more than double the levels of payments they did before, thereby reducing the company's outstanding debt.

Between 2010 and 2015, we will also be expanding our involvement with consumer organisations such as Citizens Advice and will be implementing a personalised debt advice initiative.

Pure Environment

South West Water's record of environmental achievements was further strengthened during 2009/10.

CHIEF EXECUTIVE'S REVIEW (Continued)

The company's focus on proactive maintenance of its waste water network has resulted in an 11th consecutive year without a major Category 1 pollution incident and the number of more minor Category 2 and 3 incidents remained at a low level

The long-term transformation of bathing water quality in the South West due to the £2 billion Clean Sweep programme was also safeguarded with 96.5% of bathing waters complying with the EU mandatory standard. A decade ago this figure was only 42.6%. This major improvement in quality has also helped the South West gain the most Blue Flag beaches of any region in the UK.

The percentage of population equivalent served by sanitary-compliant waste water treatment works in the calendar year 2009 stood at 99.7%. This consistently high performance contributes to the region having the highest percentage of high quality rivers in England.

A pilot moorland restoration project, 'Mires', undertaken on Exmoor between 2003 and 2010, beat strong competition to win a Water Industry Achievement Award for sustainable environmental action. The success of Mires and other environmental initiatives has led to a more extensive programme of catchment management to be implemented called 'Upstream Thinking'. Restoring wetlands will allow slower and steadier drainage and cleaner water running down from the moors to rivers and reservoirs. This will in turn help minimise long-term treatment costs.

Mires will be expanded across the region with moorland and farmland projects between 2010 and 2015 in partnership with Exmoor National Park Authority, Dartmoor National Park Authority, Natural England, the Environment Agency, English Heritage, local farmers and landowners.

Focussing on our 'Pure' vision has assisted the company in delivering a strong set of results both financially and operationally. This has also ensured there is a solid platform in place for further progress to be made. Ofwat's Final Determination represents a tough challenge for the company but it is one we have accepted and are determined to deliver.

To meet this challenge, we have

- renegotiated our key operational contracts with service partners to create more innovative ways of working and further cost efficiencies, including establishing the new incentivised 'H₂O' Delivery Alliance to deliver the capital programme
- invested in a more centralised operating structure employing increased levels of automation
- continued our organisational restructuring drive to sustain our services through flexible working while securing efficiencies. It is expected that a further £4m will be provided in 2010/11 for restructuring costs
- successfully reduced our energy consumption through our 'Megawatt Challenge' company wide initiative. Staff-led energy saving projects resulted in overall energy savings of 6.5 GWh, a reduction of around 3,500 tonnes of CO₂ and a cost saving of around £600,000 per annum. Further energy savings will be delivered by our 'PowerDown' programme which is in place to achieve further energy usage and cost reductions between 2010 and 2015.

This has been another successful year for South West Water. There have been significant improvements made in service excellence and new operational efficiencies.

I would like to thank all our staff and our suppliers for their dedicated and innovative work. Their achievements this year have ensured we are in the strongest position to deliver in the years ahead.

CHIEF EXECUTIVE'S REVIEW (Continued)

Financial Review

Against the background of an uncertain global economic recovery, South West Water has had another strong year of financial performance

Operating profit (before restructuring costs of £5.0m) is up by £4.8m (2.5%) to £196.6m, despite higher operating costs (as a result of depreciation and higher than inflation price increases) and a reduction in other sales

The company's revenue increased by £12.5m to £444.5m

- Increases tariff increases approved by Ofwat (£20.9m) and 5,000 new customer connections (£0.6m)
- Decreases customers switching to metered tariffs (£7.0m) with income from other sales decreasing by £2.0m

68% of our domestic customers now receive a metered supply

Operating costs, excluding depreciation and restructuring costs, increased by £3.9 million to £154.3 million

- Efficiency savings £4.4m in year
- Additional costs from new capital schemes £1.8m
- Price increases, including inflation £6.5m
- Lower income from assets, including property sales £1.1m
- £0.5m other cost increases offset by a reduction in cost of other sales of £1.6m

Restructuring costs were £5.0m in 2009/10 and a further £4.0m is expected to be provided in 2010/11

Despite the downturn in the property market and sales being lower than last year, property disposals in the year contributed £1.0m to profit (2009 £1.7m)

The bad debt charge increased by £0.9m from £6.4m to £7.3m. Collections performance on older debt marginally improved over the year and suggests a step on the road to recovery to historic performance for collections from these customers

The net interest charge of £64.1m was £5.8m below 2008/09 with the company benefiting from lower interest rates than last year including RPI on the index-linked bond

The overall tax charge for the year decreased by £20.6m from £51.3m to £30.7m. Within the tax charge the current corporation tax charge increased by £10.3m, from £20.5m to £30.8m, the main reason for the increase being a higher profit before tax and lower pension deficit payments (which attract relief as payments but are not charged to the income statement). In the prior year there was a non-recurring deferred tax charge of £19.1m in respect of the abolition of industrial building allowances

Capital expenditure was £143.3m, including £9.7m on advanced spend for K5. £37.6m was spent on quality schemes, principally on concluding the water mains rehabilitation programme

Further contributions totalling £9.9m were made to the defined benefit pension schemes

Further analysis of the financial results achieved in the year is presented within the Business Review on page 9

C Loughlin
Chief Executive

DIRECTORS, REGISTERED OFFICE AND AUDITORS

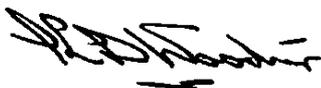
Chairman	K G Harvey
Chief Executive	C Loughlin
Operations Director	S C Bird
Finance Director	S J Davy
Customer Service Director	M S Read
Non-Executive Director	M O J Taylor (Appointed 1 st March 2010)
Secretary	K D Woodier
Registered Office	Peninsula House Rydon Lane Exeter EX2 7HR
Auditors	PricewaterhouseCoopers LLP Chartered Accountants and Statutory Auditors 31 Great George Street Bristol BS1 5QD

NOTICE OF MEETING

The twenty-first Annual General Meeting of South West Water Limited will be held at Peninsula House, Rydon Lane, Exeter on 20 July 2010 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 2010
- 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

25 June 2010

For the purposes of the appointment of auditors (Resolution 2 in this notice), Special notice in accordance with Sections 312 and 485(3), Companies Act 2006 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 2010

The company's registered number is 2366665

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's revenues rose 2.9% to £444.5m as a result of tariff increases and new connections, offset by the effects of customers switching and lower other sales.

Approved tariff increases, including the 1.4% K factor, amounted to £20.9m. The number of new water connections in the year was 5,000, a reduction from the 7,000 in the previous year. The overall impact on turnover was an increase of £0.6m, made up of additional measured turnover of £2.9m, offset by a reduction of £2.3m in connection charges income.

The effect of meter option switchers was to reduce turnover by £7.0m, benefiting 17,890 customers (2009: 23,162 customers) by, on average, about £380 each (2009: £372 each). 68% (2009: 66%) of South West Water's domestic customers are now metered.

Measured demand was consistent with the prior year after a fall of an average 4.2% in 2008/09. The improved demand compared to 2008/09 was in part reflective of the stronger tourism season in the South West.

Operating profit rose by 2.6% to £191.6m. Operating profit before restructuring costs of £5.0m (2009: £5.0m) rose by 2.5% to £196.6m.

Operating costs, excluding depreciation and restructuring, increased by £3.9m to £154.3m.

- Efficiency savings £4.4m in year
- Additional costs from new capital schemes £1.8m
- Price increases, including inflation £6.5m
- Lower income from assets, including property sales £1.1m
- £0.5m other cost increases offset by a reduction in cost of other sales £1.6m

The depreciation charge increased by £3.8m to £93.6m due to the capital programme.

The bad debt charge increased by £0.9m from £6.4m to £7.3m. The amount excluded from turnover under IFRS as being judged uncollectible reduced by £0.2m (2009: increase of £1.2m). Collections performance on older debt marginally improved over the year and suggests a step on the road to recovery to historic performance for collections from these customers.

The Ofwat target of efficiency cost savings by the end of the K4 period was achieved ahead of schedule. New efficiency projects in 2009/10 have created a platform to enable further improvements to operational and customer service performance.

REPORT OF THE DIRECTORS (continued)

Efficiencies were broadly achieved in the following areas

- Manpower costs reduction in staff numbers and overtime levels, increased productivity through mobile working and improved balance of planned to reactive work, absorption of additional work, changes in terms and conditions
- Use of materials and contracted services examples including rightsourcing reviews, improved chemical management, process rationalisation, proactive asset management philosophy with targeted investment to improve asset reliability
- Other costs reduced energy usage, more robust flow volume data reducing compliance charges, overhead reductions

The company has continued its organisational restructuring drive throughout the year costing £5m with the twin aims of sustaining our services while securing efficiencies. To support operational and service improvements, a number of employee development programmes have been completed in the year.

Investment

Total capital expenditure incurred for the year was £143.3m, a decrease of £4.5m (3.0%) from the 2009 level of £147.8m. Capital expenditure for the year included £9.7m advance expenditure on K5 projects agreed by the Regulator. Without this expenditure the reduction would have been £14.2m (9.6%).

Major outputs from the 2009/10 capital programme include

- Completion of the water mains rehabilitation programme. This was the largest element of the K4 capital programme and the final year included high profile schemes in the Exeter area. For the Topsham scheme (£2.4m) an innovative approach of installing a new pipeline because renovating the existing main would have caused major traffic disruption was chosen and received positively.
- Construction of a new 13.5km trunk main between Houndall Water Treatment Works and Roborough was completed providing additional safeguards for South Devon's water supply.
- Completion of the 16.5km 'spine main' parallel to the existing water main between Fox Park reservoir and Indian Queens in Cornwall.
- After planning delays, construction work commenced on the sewage treatment works for Boscastle, Bossiney & Tintagel.
- Delivery of major STW quality projects at St Austell Menagwins (phosphate removal) and Falmouth (nitrate removal).
- Infrastructure work for connecting Park and Stannon Lakes to the distribution network has been completed, with work starting at the end of the year on conversion of Stannon Lake to a reservoir.

Targeted investment in capital maintenance programmes ensured that serviceability was assessed as 'stable' for all the Company's areas of service.

Taxation

The overall tax charge for the year decreased by £20.6m from £51.3m to £30.7m.

Within the tax charge the current corporation tax charge increased by £10.3m, from £20.5m to £30.8m, the main reason for the increase being a higher profit before tax and lower pension deficit payments this year due to the prepayments made in the prior year (which attract relief as payments but are not charged to the income statement).

REPORT OF THE DIRECTORS (continued)

In the prior year there was a non-recurring deferred tax charge of £19.1m in respect of the abolition of industrial building allowances

Other deferred tax charges were lower by £11.8m from a charge of £11.7m in 2008/09 to a credit of £0.1m in 2009/10

Financing

Net interest payable decreased by £5.8m to £64.1m from £69.9m, reflecting generally lower interest rates, including a lower charge for the index-linked bond

Net debt at 31 March 2010 was £1,547.2m compared to £1,571.1m at 31 March 2009, a decrease of £23.9m. This compares with an increase of £115.9m in 2008/09 due mainly to a higher profit before tax and lower pension fund and dividend payments compared to the prior year when backlog payments for both produced untypically high cash outflows

At 31 March 2010 loans and finance lease obligations were £1,812.1m and the company held cash and deposits of £264.9m (of which £33.2m was on restricted deposit)

During the year the Company drew down a leasing facility of £14.4m and extended a £200m lease due for repayment by 2017 out to 2052

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. The Treasury function seeks to ensure that sufficient funding is available to meet foreseeable needs, maintain reasonable headroom for contingencies and manage interest rate risk. It operates within policies approved by the Board and does not undertake any speculative trading activity. Treasury policies and risk management are described in more detail on pages 35 to 39.

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

Short term facilities in place at 31 March 2010 and not utilised totalled £110.0m (2009 £124.0m). In addition the company has short-term uncommitted bank facilities of £60.0m (2009 £80.0m).

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 balance sheet value of derivatives moved from an overall liability position of £18.5m at 31 March 2009 to an overall liability position of £17.7m at 31 March 2010 due to the reduction of floating interest rates in the year. The movement is taken to reserves through the Statement of Comprehensive Income.

South West Water has approximately 25% of its debt index-linked to 2041-2057.

South West Water has entered into covenants with lenders. Whilst terms vary, these typically provide for limits on gearing (primarily based on Regulatory Capital Value) and interest cover.

Redemption penalties included in the facility documentation can be invoked if debt facilities are redeemed early. The redemption penalties vary in each facility.

REPORT OF THE DIRECTORS (continued)

The financial covenants included in the company's debt facilities are monitored on a regular basis and these have been met throughout the year. The financial covenants accepted by the company include a provision to re-test the covenants applying frozen GAAP accounting standards. This is to protect the company from changes in accounting standards that may have a detrimental impact on the financial covenant testing methodology.

South West Water's debt to Regulatory Capital Value (RCV) was 60.6% at 31 March 2010 (2008/09 63.8%), within Ofwat's 'optimum range' of 55% - 65%.

The Board regularly monitors the Company's expected financial requirements for the next 12 months. These will be met from existing cash balances, loan facilities and cash flows for the coming year.

The Company has considerable financial resources and operates in a relatively stable, regulated business environment. Consequently the Directors believe that the Company is well positioned to manage its business risks successfully despite the current uncertain general economic outlook.

Going concern

Having considered the company's funding position and financial projections, the Directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

Dividends and reserves

Dividends totalling £54.4m (2009 £103.8m) were paid to the parent undertaking, representing a base dividend for 2009/10 of £53.3m plus an additional £1.1m in respect of the previous two years taking into account actual movements in RPI. (The 2008/09 figure represented a 'catch up' after the share capital reduction during that year created sufficient distributable reserves on a statutory, IFRS basis, to release a backlog). These dividends were calculated with reference to the projections in the Ofwat Final Determination.

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 shareholder's 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 K4 period

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

REPORT OF THE DIRECTORS (continued)

Principal risks and uncertainties

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

Risk	Mitigation
Tighter price controls over the revenue of the company's regulated business	The current periodic review was completed in November 2009 when Ofwat set water company charges for the years 2010 – 2015. South West Water has met Ofwat's efficiency expectations in the last three Periodic Review periods.
Failure to deliver the capital investment programme	The company has a track record of delivering its capital programme in accordance with regulatory requirements and progress is regularly monitored and reviewed. The K4 capital programme has been delivered and the company has developed plans to deliver the K5 programme.
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. Treasury policies and risk management are described in more detail on pages 35 to 39.
Failure to deliver operating cost savings implicit in the regulatory review	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 to contribute towards the additional efficiencies required for the K5 period.
Environmental regulations and quality standards could increase the company's costs	These issues are addressed through the five year regulatory price 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	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.

REPORT OF THE DIRECTORS (continued)

Risk	Mitigation
Non-recovery of customer debt	In addition to existing strategies, which are kept under review, South West Water continues to implement new initiatives to improve and secure cash collection, including the use of property charging orders Stretching debt and collection targets – with incentives – have been agreed with our customer service contractor The accounts of major customers are kept under close review Provision has been made in the K5 Final Determination for companies to make an application for an Interim Determination in the event of household bad debts being significantly above the amount allowed by the water regulator due to worsening economic circumstances in the company's operating area
Pension costs may increase due to factors outside the company's control	All defined benefit schemes have been closed to new entrants and replaced by defined contribution arrangements
Poor investment performance may affect the defined benefit scheme assets and increase the pension scheme deficit	Employee and employer contributions are also kept under review and have been increased Further contributions of £9.9m were made in the year Pension trustees keep investment policy under review and use professional investment advisers
Water resource adequacy	The company has a number of schemes in place to maintain water resources (such as pumped storage for certain reservoirs) and promotes conservation measures 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
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 reduced demand experienced in the K4 regulatory period has been taken into account by the regulator in setting a baseline turnover level for the K5 period A revenue correction mechanism is in place from the start of the K5 period, which allows water companies to recover a shortfall in income for a five year regulatory period in the next period

REPORT OF THE DIRECTORS (continued)

Risk	Mitigation
Financial loss arising from the insolvency of a major supplier or contractor	The company does not have material exposure to payment before receipt of goods and services The company uses a third party credit monitoring service for changes to major suppliers' financial status and creditworthiness to supplement an annual risk review of key and strategic suppliers
Impact of competition in the industry	South West Water continues to consider and evaluate developments and proposals in relation to development of competition as part of its risk management and business strategic planning processes. Legislation will be required for any further extension of competition in the water and sewerage markets

The Directors have established a formal framework for the identification and monitoring of both operational and financial risks arising from the Company's activities

REPORT OF THE DIRECTORS (continued)

Key Performance Indicators (KPIs) – Pure Water

In 2009/10, South West Water abstracted 160,771 Megalitres (MI) of raw water from its 82 licensed abstraction locations which have a total licensed volume of 388,366 MI. The abstraction sources are reservoirs and rivers, accounting for 93% of supplies, with 7% drawn from groundwater aquifers.

Drinking Water Compliance

Tap water quality, as measured by Mean Zonal Compliance, is the Drinking Water Inspectorate's preferred method for water quality assessment. In 2009 we maintained the best ever compliance value of 99.98% (2008: 99.98%).

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 2008/09 South West Water's performance moved to eighth place amongst the ten water and sewerage companies (seventh in 2007/08) but the number of OPA points for that year increased from 380 to 394. For 2009/10 the number of OPA points increased further to 411 but the relative places of water and sewerage companies have not yet been published.

Ofwat has announced that OPA will be replaced with a new measure of water industry customer performance called the Service Incentive Mechanism. 2010/11 data will be reported on this new basis.

Customer Satisfaction Call Handling

Ofwat measures the overall manner in which a customer call is handled. The measure is obtained by quarterly tracking surveys undertaken by an independent company engaged and managed by Ofwat. The data is averaged for the year to assess a performance trend. For 2009/10 the satisfaction score was 4.53 (2008/09: 4.5). The maximum score is 5.0.

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 population equivalent served by sanitary-compliant waste water treatment works in the calendar year 2009 was 99.70% (99.50% in 2008).

This consistently high performance contributes to South West Water's region having the highest percentage length of high quality rivers in England.

REPORT OF THE DIRECTORS (continued)

Incidents and Prosecutions

There were no Category 1 incidents for the 11th year in succession. Two Category 2 (significant pollution) events and 69 Category 3 events were recorded by the Environment Agency in 2009 which were deemed non-compliant with discharge consents. This compares with three Category 2 incidents and 64 Category 3 incidents in 2008. The total number of waste water pollution incidents in 2009 was 106 (2008: 92). 41% of the Category 2 and 3 incidents in 2009 were identified by the company and self-reported.

During the year the company was convicted on four occasions for environmental offences and fined a total of £11,500 (2008/09: four convictions and fines of £28,100).

The company always self-reports incidents it becomes aware of and co-operates fully with any investigation undertaken by 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

Compliance with the mandatory EU bathing water standard was 96.5% in the 2009 calendar year, a marked contrast to a decade ago when compliance was only 42.6%. This compares to 93.1% for 2008. In 2009, all but 5 of the region's 144 bathing waters achieved the EU mandatory standard and 73.6% achieved the more stringent EU Guideline standard (72.2% in 2008).

Key Performance Indicators – Financial and Business

Growth in Regulatory Capital Value

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 2010 amounted to £2,620.9m. After adjustment for AMP5 log up/down and other Final Determination adjustments the figure is £2,554.9m which represents an increase of 3.8% in the year. From 31 March 2005 to 31 March 2010 the company achieved a 31% growth in RCV, the highest percentage increase of any quoted UK water company.

Net debt decreased by £23.9m to £1,547.2m, with the gearing ratio in relation to adjusted year-end RCV of £2,554.9m moving to 60.6% from 63.8%.

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 operating profit (before restructuring costs of £5.0m) of £196.6m in 2009/10, up £4.8m from 2008/09.

Key Performance Indicators – Health and Safety Performance

The health, safety and welfare of South West Water's employees remain paramount in all its activities. The company has a health and safety strategy which focuses on providing strong leadership, engaging with employees, building competence and measuring performance. These principles are promoted by a health and safety steering group comprising a cross-section of directors, managers and employee representatives.

REPORT OF THE DIRECTORS (continued)

Occupational health and safety are key elements of South West Water's risk management and internal control processes. We continue to pursue initiatives to improve further the welfare of the company's employees through the provision of training on and promotion of good health and practices.

RIDDOR incidents per 1,000 employees totalled 13 in 2009 compared to 21 in 2008 and we welcome this improvement.

Customer, Community and Employees

Customers

South West Water has consulted with customers about its priorities for 2010-2015 and this feedback has been central to the development of its customer service improvement plans to deliver its Pure Water, Pure Service and Pure Environment strategy.

Providing help and support to customers in need is at the heart of the company's Pure Service strategy and accordingly the company remains an industry leader in the provision of priority services to vulnerable customers. In 2009/10 the company has helped thousands of customers with reading their meter or by providing extra help in an emergency.

'WaterCare', the company's industry-leading scheme to support customers who have difficulty in paying their bills, completed a third successful year. Since the start of the programme over 7,000 customers have been helped with benefit entitlement checks, tariff advice and water-saving measures. The 'WaterCare' programme has been commended by the Government.

Customers are kept informed about our services through 'WaterLevel', our company newspaper, leaflets, the media and our website www.southwestwater.co.uk. Consultation with customers and stakeholders has an influence on the improvements made to our literature and website as we seek to provide information of interest in increasingly accessible ways.

The company meets regularly with the Consumer Council for Water (CCWater), which champions the interests of water customers. It regularly consults with CCWater and other stakeholders such as pensioners' forums and Citizens Advice, prior to introducing major changes or initiatives.

The company continues to promote the efficient use of water with advice and practical support for householders and non-domestic customers.

South West Water continues to support business customers through water efficiency reviews, waste minimisation projects, providing advice for water management plans and by highlighting opportunities for reduction, re-use or alternative sources of supply. An education programme for schools has also been developed this year to extend the spread and reach of this work. As part of the 'WaterCare' programme and to investigate customers' high water consumption queries 2,831 audits were completed in 2009/10 (2008/09 3,088).

Business customers continue to have access to a secure online system which tracks and displays consumption on their sites. South West Water's 'Business Accounts Online' also offers a water efficiency calculator with a free water audit.

No single customer accounts for more than 1% of revenue.

Community, Corporate Responsibility 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.

REPORT OF THE DIRECTORS (continued)

Highlights in 2009/10 included the staging of a series of environmental walks with Cornwall Wildlife Trust around the coastline to mark the completion of a pipe replacement scheme at Looe and the sponsoring of the 'Nipper' youth championships of the Surf Life Saving Association of Great Britain at Falmouth

Other supported events ranged from the TRAIL environmental art sculpture festival on the South West Coast Path between Dawlish and Shaldon and the opening of Pynes Water Treatment Works, Brokenbury Waste Water Treatment Works and Mary Tavy Hydro for guided public tours during the national Heritage Open Days

For the third year, the company also co-sponsored South West Tourism's annual awards and funded the sustainable tourism prize. This demonstrates how its 'Clean Sweep' project has helped underpin the renaissance of tourism, the region's number one industry. The company is also proud to continue to support the water industry charity, WaterAid, through sponsorship and many other fund-raising activities such as the publication of a calendar featuring water-themed photographs taken by Group employees

South West Water achieved a 'Green Apple' award for transforming a disused sludge lagoon into a pond for wildlife with a number of other habitat improvements around the water treatment works site at Tottiford, near Bovey Tracey. This project was shortlisted as a finalist in the Community Campaign of the Year category of the Water Industry Achievement Awards. This recognises the way South West Water engaged with adults with learning difficulties for the supply of bat, bird and dormouse boxes now fitted across the site

Employees

South West Water's people strategy continues to focus on recruiting and developing individuals who can support the delivery of the company's 'Pure' vision, enabling the provision of a high quality service to customers and the achievement of operational efficiencies

Technical and managerial skills training have underpinned the company's Puros project. A range of other programmes to support the development of customer facing and operational skills continue to form a fundamental part of our strategy

Employee involvement and participation in all aspects of business and organisational change is encouraged and supported through the company's Staff Council, and craft and industrial consultative forums

The company holds the 'Investor in People' (IIP) Silver Status, which represents the achievement of a high standard in IIP evidence requirements

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

The 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 re-train people who become disabled during their employment in order to maintain their employment within the Company

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 partnering and strategic alliances with 60 key suppliers who account for the large 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 whilst improving performance and service levels.

The company has successfully completed a tender programme of strategic contracts in preparation for the K5 (2010 to 2015) period and has established a new 'H₂O Alliance' structure for delivery of its 2010-15 capital programme. This will enable the company to work closely with suppliers, particularly small and medium-sized businesses across the South West, ensuring value-for-money for customers and supporting the regional economy.

No supplier (revenue) accounts for more than 5% of the turnover and South West Water sources all its purchases from competitive markets.

Payments to suppliers

It is the Company's payment policy for the year ending 31 March 2011 to follow the Code of The Better Payment Practice Group on supplier payments. The Company will agree payment terms with individual suppliers in advance and abide by such terms. Information about the Code may be obtained from The Better Payment Practice Group's website at www.payontime.co.uk. Trade creditors at 31 March 2010 represented 26 days of the amount invoiced by suppliers during the year (2009: 29).

FUTURE DEVELOPMENTS

The key factor affecting the Company's performance for 2010/11 is the Periodic Review completed in November 2009 when Ofwat set water company charges for the years 2010-2015 giving 'K' price increases of 1.1%, 3.4%, 2.5%, 1.3%, and 1.1% for 2010-2015 (an average of 1.9% p.a. over the five years). It also determined the investment outputs to be delivered by the Company over this period.

REPORT OF THE DIRECTORS (continued)

Key elements of the Ofwat Final Determination for South West Water included

- A cost of capital of 4.5% (real, post tax basis) applicable to the whole industry
- 'K' price increases (above RPI inflation) averaging 1.9% per annum over the five years
- A capital programme of around £705m at 2007/08 prices
- A Capital Incentive Scheme (CIS) score of 105 (water) and 110 (sewerage), in line with the industry average
- Operating efficiency improvements of 2.8% per annum, comparable with K4 delivery
- Over the period 2010-2015 average bills decreasing by 1% before inflation
- Capital investment priorities, including protection and maintenance of the improvements made over the last 20 years, further improvements to meet EU Directives and their corresponding UK legislation, achievement of operating cost savings and delivery of projects to increase our levels of renewable energy generation and to improve sustainability of the company's activities

Summary information on the final plan is available on the company's website southwestwater.co.uk

DONATIONS

During the year, charitable donations amounting to £1,600 were made (2009 £7,000). No political donations were made in the current or prior year.

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 7.

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.

PARENT COMPANY

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

STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE ANNUAL REPORT AND THE FINANCIAL STATEMENTS

The directors are responsible for preparing the Annual 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 elected to prepare the financial statements in accordance with International Financial Reporting Standards (IFRSs) 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 that period.

REPORT OF THE DIRECTORS (continued)

In preparing those 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 IFRSs as adopted by the European Union,
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business, in which case there should be supporting assumptions or qualifications as necessary

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 enable them to ensure that the financial statements comply with the Companies Act 2006. 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

The directors are responsible for the maintenance and integrity of the company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions

STATEMENT AS TO DISCLOSURE OF INFORMATION TO AUDITORS

- a) so far as each director is aware, there is no relevant audit information of which the company's auditors are unaware, and
- b) they have taken all the steps that he ought to have taken 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

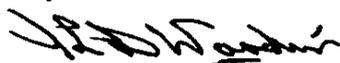
AUDITORS

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 twenty first annual general meeting will be held at Peninsula House, Rydon Lane, Exeter on 20 July 2010 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 2010 which comprise the Income Statement, the Statement of Comprehensive Income, the Balance sheet, the Statement of Changes in Equity, the Cash Flow Statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement set out on page 21, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, 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.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the directors, and the overall presentation of the financial statements.

Opinion on financial statements

In our opinion the financial statements

- give a true and fair view of the state of the company's affairs as at 31 March 2010 and of its profit and cash flows for the year then ended,
- have been properly prepared in accordance with IFRSs as adopted by the European Union, and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

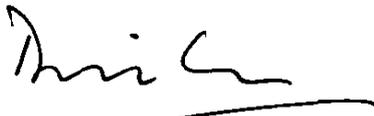
In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

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

Matters on which we are required to report by exception

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

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us, or
- the financial statements are not in agreement with the accounting records and returns, or
- certain disclosures of directors' remuneration specified by law are not made, or
- we have not received all the information and explanations we require for our audit



David Charles (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Bristol
25 June 2010

Income statement for the year ended 31 March 2010

	Notes	2010 £m	2009 £m
Revenue	5	444.5	432.0
Operating costs	6		
Manpower costs (excluding restructuring costs)		(32.8)	(32.9)
Raw materials and consumables used		(14.2)	(13.2)
Other operating expenses		(107.3)	(104.3)
Depreciation		(93.6)	(89.8)
Restructuring costs	26	(5.0)	(5.0)
Operating profit		191.6	186.8
Finance costs	7	(83.9)	(99.6)
Finance income	7	19.8	29.7
Profit before tax		127.5	116.9
Taxation	8	(30.7)	(51.3)
Profit for the year		96.8	65.6

All operating activities are continuing activities

Statement of comprehensive income for the year ended 31 March 2010

	Notes	2010 £m	2009 £m
Profit for the year		96.8	65.6
Actuarial losses on defined benefit schemes	24	(32.8)	(50.6)
Cash flow hedges net fair value losses		(1.2)	(19.0)
Tax on items taken directly to equity	25	14.1	13.9
Total other comprehensive income		(19.9)	(55.7)
Total comprehensive income for the year		76.9	9.9

Statement of changes in equity

	Share Capital (Note 27) £m	Retained earnings and other reserves (Note 29) £m	Total Equity £m
At 1 April 2008	450.9	43.2	494.1
Profit for the year	-	65.6	65.6
Other comprehensive income for the year	-	(55.7)	(55.7)
Total comprehensive income for the year	-	9.9	9.9
Transactions with equity shareholders			
Dividends paid	-	(103.8)	(103.8)
Share based payments (net of tax)	-	0.4	0.4
Reduction in share capital	(300.0)	300.0	-
Total transactions with equity shareholders	(300.0)	196.6	(103.4)
At 31 March 2009	150.9	249.7	400.6
Profit for the year	-	96.8	96.8
Other comprehensive income for the year	-	(19.9)	(19.9)
Total comprehensive income for the year	-	76.9	76.9
Transactions with equity shareholders			
Dividends paid	-	(54.4)	(54.4)
Share based payments (net of tax)	-	0.7	0.7
Total transactions with equity shareholders	-	(53.7)	(53.7)
At 31 March 2010	150.9	272.9	423.8

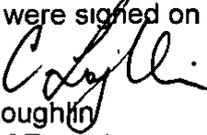
The notes on pages 29 - 67 form part of these financial statements

Balance sheet at 31 March 2010

	Notes	2010 £m	2009 £m
Assets			
Non-current assets			
Property, plant and equipment	12	2,425.7	2,377.9
Investment in subsidiary undertakings	15	3.3	3.3
Investment in joint venture	15	0.1	0.1
Trade and other receivables	14	0.4	1.1
Derivative financial instruments	18	-	0.2
		<u>2,429.5</u>	<u>2,382.6</u>
Current assets			
Inventories	16	3.5	4.1
Trade and other receivables	17	70.6	66.5
Cash and cash deposits	19	264.9	251.7
		<u>339.0</u>	<u>322.3</u>
Liabilities			
Current liabilities			
Borrowings	22	(155.3)	(55.3)
Derivative financial instruments	18	(3.6)	(2.1)
Trade and other payables	20	(72.6)	(69.4)
Current tax liabilities	21	(51.9)	(23.2)
Provisions for liabilities and charges	26	(3.1)	(0.3)
		<u>(286.5)</u>	<u>(150.3)</u>
Net current assets		<u>52.5</u>	<u>172.0</u>
Non-current liabilities			
Borrowings	22	(1,656.8)	(1,767.5)
Other non-current liabilities	23	(1.4)	(1.6)
Derivative financial instruments	18	(14.1)	(16.6)
Retirement benefit obligations	24	(83.3)	(51.4)
Deferred tax liabilities	25	(302.6)	(316.9)
		<u>(2,058.2)</u>	<u>(2,154.0)</u>
Net assets		<u>423.8</u>	<u>400.6</u>
Shareholders' equity			
Share capital	27	150.9	150.9
Retained earnings and other reserves	29	272.9	249.7
Total shareholders' equity		<u>423.8</u>	<u>400.6</u>

The notes on pages 29 to 67 form part of these financial statements

The financial statements on pages 25 to 67 were approved by the Board of Directors on 25 June 2010 and were signed on its behalf by


C Loughlin
Chief Executive

Cash flow statement for the year ended 31 March 2010

	Notes	2010 £m	2009 £m
Cash flows from operating activities			
Cash generated from operations	30	279.2	231.3
Interest paid		(60.1)	(67.7)
Tax paid		(1.3)	(21.8)
Net cash generated from operating activities		217.8	141.8
Cash flows from investing activities			
Interest received		3.7	11.6
Receipt of grants and contributions		0.4	1.1
Purchase of property, plant and equipment		(145.3)	(156.9)
Proceeds from sale of property, plant and equipment		1.3	2.2
Net cash used in investing activities		(139.9)	(142.0)
Cash flows from financing activities			
Deposit of restricted funds		(16.2)	(5.9)
Net proceeds from new borrowing		-	100.0
Repayment of borrowings		(14.1)	(14.2)
Finance lease sale and lease back		14.4	25.4
Finance lease principal repayments		(11.3)	(10.6)
Dividends paid		(54.4)	(103.8)
Loans to parent company repaid		-	16.8
Net cash (used in)/received from financing activities		(81.6)	7.7
Net (decrease)/ increase in cash and cash deposits		(3.7)	7.5
Cash and cash deposits at beginning of the year	19	218.1	210.6
Cash and cash deposits at end of the year	19	214.4	218.1

The notes on pages 29 to 67 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 2006. The address of the registered office is given on page 7. The nature of the Company's operations and its principal activities are set out in the Directors' report on page 9.

These financial statements were approved by the Board of Directors on 25 June 2010.

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 (IFRSs) and International Financial Reporting Interpretation Committee (IFRIC) interpretations, as adopted by the European Union, with those parts of the Companies Act 2006 applicable to companies reporting under IFRS. A summary of the principal accounting policies is set out below, together with an explanation where changes have been made to previous policies on the adoption of new accounting standards in the year.

IAS 1 "Presentation of financial statements" (revised)

The revised standard requires non-owner changes in equity to be presented separately from owner changes in equity. The Company has elected to present two statements, an income statement and a statement of comprehensive income.

IFRS 7 "Financial Instruments Disclosures" (amendment)

The amended standard requires the classification of fair value measurements using a fair value hierarchy which reflects the significance of the inputs used in making the measurement. Additional disclosure has been made in these financial statements.

The following revised standards, amended standards and interpretations, which are mandatory for the first time in the financial year beginning 1 April 2009, are relevant to the Company but have no material impact.

IFRS 8 "Operating segments"

IAS 23 "Borrowing costs" (revised)

IFRS 2 "Share-based payment" (amendment)

IAS 32 "Financial instruments presentation" (amendment) and consequential amendments to IAS 1 "Presentation of financial statements"

Improvements to IFRSs 2008

IAS 39 "Financial instruments recognition and measurement" (amendment)

IAS 39 "Financial instruments recognition and measurement" (amendment) and consequential amendments to IFRS 7 "Financial instruments disclosures"

IFRIC 9 & IAS 39 "Reassessment of embedded derivatives" amendments to IFRIC 9 and IAS 39 regarding embedded derivatives"

NOTES TO THE FINANCIAL STATEMENTS

2 Principal accounting policies (continued)

(a) Basis of preparation (continued)

IFRIC 12	"Service concession arrangements"
IFRIC 14	"IAS 19 – the limit on a defined benefit asset, minimum funding requirements and their interaction"

At the date of approval of these financial statements the following standards and interpretations, which have not been applied in these financial statements, were in issue but not yet effective

IAS 27	"Consolidated and separate financial statements" (revised)
IFRS 3	"Business combinations" (revised)
Improvements to IFRSs 2009	
IFRS 2	"Share-based payment" (amendment)
IFRS 1	"First-time adoption of IFRS" (revised)
IAS 32	"Financial instruments presentation"
IFRS 9	"Financial instruments"
IAS 24	"Related party disclosures"
IFRS 1	"First-time adoption of IFRS" (amendment)
IFRIC 14	"Prepayments of a minimum funding requirement" (amendment)
IFRIC 15	"Agreements for the construction of real estate"
IFRIC 16	"Hedges of a net investment in a foreign operation"
IFRIC 17	"Distribution of non-cash assets to owners"
IFRIC 18	"Transfers of assets from customers"
IFRIC 19	"Extinguishing financial liabilities with equity instruments"

The presentational impact of these standards and interpretations is being assessed and 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 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. Details of critical accounting judgements and estimates are set out in note 4.

(b) Basis of consolidation

The Company is exempt under the provisions of section 440 of the Companies Act 2006 from the requirement to produce group financial statements 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.

NOTES TO THE FINANCIAL STATEMENTS

2 Principal accounting policies (continued)

(c) Revenue recognition

Revenue comprises charges to customers for water, sewerage and other services excluding value added tax and is derived only from the United Kingdom

Revenue is recognised when the service has been provided to the customer

Revenue relates to charges due in the year, excluding any amounts paid in advance. Revenue for measured charges includes amounts billed plus an estimation of the amounts unbilled at the year end. The accrual for unbilled charges is estimated using a defined methodology reflecting historical consumption, estimated demand trends and current tariffs. Revenue for unmeasured charges is recognised on a time apportioned basis.

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 were 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.

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
Operational structures	40 – 80 years
Fixed plant	20 – 40 years
Vehicles, mobile plant and computers	4 – 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.

NOTES TO THE FINANCIAL STATEMENTS

2 Principal accounting policies (continued)

(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) Investment in subsidiary undertakings

Investments in subsidiary undertakings are initially recorded at cost, being the fair value of the consideration paid, including associated acquisition costs. Subsequently, investments are reviewed for impairment on an individual basis annually or if events or changes in circumstances indicate that the carrying value may not be fully recoverable.

(h) Joint ventures

Joint ventures are entities over which the Company exercises joint control. Investments in joint ventures are accounted for using the equity method of accounting. Any excess of the cost of acquisition over the Company's share of the fair values of the identifiable net assets of the joint venture at the date of acquisition is recognised as goodwill and is included in the carrying value of the investment in the joint venture.

The carrying value of the Company's investment is adjusted for the Company's share of post-acquisition profits or losses recognised in the income statement and statement of comprehensive income. Losses of a joint venture in excess of the Company's interest are not recognised unless the Company has a legal or constructive obligation to fund those losses.

(i) Inventories

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

(j) 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)

(k) 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)

(k) Derivatives and other financial instruments (continued)

iv) *Trade payables*

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

(l) 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.

(m) 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.

(n) Employee benefits

i) *Pension obligations*

The company operates defined benefit and defined contribution pension schemes through its 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.

Costs of the defined contribution pension scheme are charged to the income statement in the period in which they arise.

NOTES TO THE FINANCIAL STATEMENTS

2 Principal accounting policies (continued)

(n) Employee benefits

ii) *Share-based payment*

The Company participates in a number of equity-settled share-based payment plans for employees operated by its parent company Pennon Group Plc. The fair value of the employee services required in exchange for the grant is recognised as an expense over the vesting period of the grant.

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

(o) 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.

NOTES TO THE FINANCIAL STATEMENTS

3 Financial risk management (continued)

(a) Financial risk factors (continued)

i) Market risk

The Company has both interest bearing assets and interest bearing liabilities. The Company has a policy of maintaining, after the effect of interest rate swaps, at least 50% of interest bearing liabilities at fixed rates. At the year end 73% of net borrowings were at fixed rates and 23% 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 18.

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 2010, 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 higher/lower by £2.3m (2009: £1.5m).

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

31 March 2010

	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 liabilities	114.1	21.1	73.3	849.8	1,058.3
Interest payments on borrowing	7.8	8.4	29.0	343.7	388.9
Finance lease liabilities	38.1	38.7	176.2	2,307.7	2,560.7
Derivative financial liabilities					
Derivative contracts – net (payments)	14.3	8.3	12.9	-	35.5

NOTES TO THE FINANCIAL STATEMENTS

3 Financial risk management (continued)

ii) Liquidity risk (continued)

Contractual undiscounted cash flows were

31 March 2009	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 liabilities	14 1	114 1	63 3	897 7	1,089 2
Interest payments on borrowing	12 7	10 6	32 3	367 4	423 0
Finance lease liabilities	55 9	56 2	248 8	1,947 2	2,308 1
Derivative financial liabilities					
Derivative contracts – net receipts	(16 4)	(4 6)	(3 0)	(0 3)	(24 3)

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.

NOTES TO THE FINANCIAL STATEMENTS

3 Financial risk management (continued)

(b) Capital risk management (continued)

The gearing ratios at 31 March 2010 and 2009 were as follows

	2010 £m	2009 £m
Net borrowings (note 31)	1,547.2	1,571.1
Total equity	423.8	400.6
Total capital	<u>1,971.0</u>	<u>1,971.7</u>
Gearing ratio	<u>78.5%</u>	<u>79.7%</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

	2010 £m	2009 £m
Regulatory Capital Value	2,554.9	2,461.0
Net borrowings (note 31)	1,547.2	1,571.1
Debt / Regulatory Capital Value	<u>60.6%</u>	<u>63.8%</u>

(c) Determination of fair values

Effective 1 April 2009, the Company adopted the amendment to IFRS 7 for financial instruments which are measured in the balance sheet at fair value, this requires disclosure of fair value measurements by level of the following fair value measurement hierarchy

- Quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1)
- Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) (level 2)
- Inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs) (level 3)

The disclosures are set out in note 18

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

NOTES TO THE FINANCIAL STATEMENTS

3 Financial risk management (continued)

(c) Determination of fair values (continued)

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

Revenue recognition

Revenue is recognised by the Company when 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 waste water 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 historical 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. Revenue for unmeasured charges is recognised on a time apportioned basis.

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 2010 current trade receivables were £76.0m, before provision for impairments.

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 2010 was £2,425.7m (2009 £2,377.9m). In the year ended 31 March 2010 additions to property, plant and equipment totalled £143.3m and the depreciation charge was £94.9m. 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.

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.

Taxation

The corporation tax position reflects management's estimation of the amount of tax payable for fiscal years with open tax computations where liabilities remain to be agreed by Her Majesty's Revenue and Customs.

5 Segmental reporting

The Directors believe that the whole of the Company's activities constitute a single class of business. Operating segments are reported in the manner consistent with internal reporting to the Chief Operating Decision Maker, which has been identified as the Board of Directors.

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

NOTES TO THE FINANCIAL STATEMENTS

6	Operating costs	2010	2009
		£m	£m
	Manpower costs (note 10)	<u>32.8</u>	<u>32.9</u>
	Raw materials and consumables	<u>14.2</u>	<u>13.2</u>
	Other operating expenses include		
	Profit on disposal of property, plant and equipment	(1.0)	(1.7)
	Operating lease rentals payable		
	- Plant and machinery	0.8	0.7
	- Property	1.4	1.3
	Research and development expenditure	0.2	0.2
	Trade receivables impairment (note 17)	<u>7.3</u>	<u>6.4</u>
	Depreciation of property, plant and equipment		
	- Owned assets	64.4	63.4
	- Under finance leases	<u>29.2</u>	<u>26.4</u>
		<u>93.6</u>	<u>89.8</u>
	Fees payable to the Company's auditors in the year were as follows		
		2010	2009
		£000	£000
	Audit of the Company's accounts	108	100
	Audit-related regulatory reporting	28	124
	Other services	<u>79</u>	<u>24</u>
		<u>215</u>	<u>248</u>
	Expenses reimbursed to the auditors in relation to the audit of the Company were £14,000 (2009 £14,000)		
7	Net finance costs	2010	2009
		£m	£m
	Finance Costs		
	Intercompany interest payable to subsidiaries	(10.8)	(12.7)
	Bank borrowings and overdrafts	(10.9)	(10.5)
	Interest element of finance lease rentals	(44.7)	(53.8)
	Other finance costs	-	(3.8)
	Interest cost on retirement benefit obligations	<u>(17.5)</u>	<u>(18.8)</u>
		<u>(83.9)</u>	<u>(99.6)</u>
	Finance Income		
	Interest receivable	4.0	10.2
	Intercompany interest receivable from subsidiaries	0.1	1.7
	Expected return on pension scheme assets	15.0	17.8
	Other finance income	<u>0.7</u>	<u>-</u>
		<u>19.8</u>	<u>29.7</u>
	Net finance costs	<u>(64.1)</u>	<u>(69.9)</u>

NOTES TO THE FINANCIAL STATEMENTS

8	Taxation	2010 £m	2009 £m
	Analysis of charge in year		
	Current tax	30.8	20.5
	Deferred tax (note 25)	(0.1)	11.7
	Deferred tax effect of abolition of industrial building allowances (note 25)	-	19.1
		30.7	51.3

UK Corporation tax is calculated at 28% (2009 28%) of the estimated assessable profit for the year. The tax for the year differs from the theoretical amount that would arise using the standard rate of corporation tax in the UK (28%). The differences are explained below.

	2010 £m	2009 £m
Profit before tax	127.5	116.9
Profit before tax multiplied by standard rate of corporation tax in the UK of 28% (2009 28%)	35.7	32.7
Effects of		
Expenses not deductible for tax purposes	0.5	0.7
Other	(2.8)	(0.3)
Adjustments to tax charge in respect of prior year	(2.7)	(0.9)
Effect of deferred tax on abolition of industrial buildings allowances	-	19.1
Tax charge for year	30.7	51.3

The average applicable tax rate for the year was 24% (2009 44% due to the one off effect of the abolition of industrial buildings allowances as set out above).

In addition to the amount credited to the income statement, a deferred tax credit relating to actuarial losses on defined benefit schemes of £9.2m (2009 charge on actuarial gains £14.2m) has been charged directly to equity. A deferred tax charge relating to share-based payments of £0.1m (2009 tax credit £0.3m) has been charged to equity.

NOTES TO THE FINANCIAL STATEMENTS

9	Dividends	2010	2009
		£m	£m
	Amounts recognised as distributions to equity holders in the year		
	2006/07 Outperformance dividend	-	3.6
	Base dividend of 66.4p per ordinary share in respect of 2007/08 and 2008/09 paid 30 January 2009	-	100.2
	Base dividend of 36.0p per ordinary share in respect of 2009/10 paid 13 November 2009	54.4	-
		<u>54.4</u>	<u>103.8</u>

10 Employment costs

The average number of persons (including Directors) employed by the Company was 1,191 (2009 1,227)

	2010	2009
	£m	£m
Employment costs comprise		
Wages and salaries	33.7	33.0
Social security costs	2.7	2.5
Pension costs	9.5	7.9
Share-based payments	1.3	1.2
Total employment costs	<u>47.2</u>	<u>44.6</u>
Charged as follows		
Manpower costs	32.8	32.9
Capital schemes	10.0	9.5
Restructuring provision	4.4	2.2
Total employment costs	<u>47.2</u>	<u>44.6</u>

Details of Director's 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	Directors' emoluments	2010	2009
		£000	£000
	Total emoluments of the Directors of the Company		
	Salary	611	602
	Fees (non-executive Director)	3	-
	Performance related	240	159
	Share-based payments	408	289
	Other emoluments	132	133
	Total emoluments	<u>1,394</u>	<u>1,183</u>

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

Performance related, share-based payments and other emoluments apply to Executive Directors only

The performance related payment represents the cash element. In addition, Executive Directors receive a conditional award of shares in Pennon Group Plc 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

The emoluments of the highest paid Director were £466,000 (2009 £421,000)

At 31 March 2010 retirement benefits were accruing to 3 Directors (2009 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
Cost :						
At 1 April 2008	17.6	1,249.1	593.6	979.7	107.5	2,947.5
Additions	0.5	53.7	1.7	29.0	62.9	147.8
Grants & contributions	-	(1.9)	-	-	-	(1.9)
Disposals	(0.3)	(0.7)	-	(1.7)	-	(2.7)
Transfers/reclassifications	1.1	34.0	10.5	35.0	(80.6)	-
At 31 March 2009	18.9	1,334.2	605.8	1,042.0	89.8	3,090.7
Additions	0.6	36.0	0.8	33.1	72.8	143.3
Grants & contributions	-	(0.4)	-	-	-	(0.4)
Disposals	-	(0.7)	(0.2)	(13.6)	-	(14.5)
Transfers/reclassifications	0.9	36.3	8.1	35.5	(80.8)	-
At 31 March 2010	20.4	1,405.4	614.5	1,097.0	81.8	3,219.1
Depreciation :						
At 1 April 2008	4.0	43.9	145.2	430.6	-	623.7
Charge for year	0.3	18.7	11.1	61.2	-	91.3
Disposals	(0.1)	(0.7)	-	(1.4)	-	(2.2)
At 31 March 2009	4.2	61.9	156.3	490.4	-	712.8
Charge for year	0.3	20.5	11.2	62.9	-	94.9
Disposals	-	(0.7)	(0.2)	(13.4)	-	(14.3)
At 31 March 2010	4.5	81.7	167.3	539.9	-	793.4
Net book value :						
At 31 March 2009	14.7	1,272.3	449.5	551.6	89.8	2,377.9
At 31 March 2010	15.9	1,323.7	447.2	557.1	81.8	2,425.7

Out of the total depreciation charge for the Company of £94.9m (2009 £91.3m), the sum of £1.3m (2009 £1.5m) has been charged to capital projects, and £93.6m (2009 £89.8m) 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
Cost						
At 31 March 2009	-	350.1	444.9	312.5	25.0	1,132.5
At 31 March 2010	-	355.0	459.9	299.1	9.7	1,123.7
Depreciation						
At 31 March 2009	-	15.4	73.8	150.5	-	239.7
At 31 March 2010	-	20.6	81.5	142.0	-	244.1
Net book amount						
At 31 March 2009	-	334.7	371.1	162.0	25.0	892.8
At 31 March 2010	-	334.4	378.4	157.1	9.7	879.6

13 Financial instruments by category

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

	Note	Fair value	Amortised cost		Total £m
		Derivatives £m	Loans and receivables £m	Trade receivables and trade payables £m	
31 March 2010					
Financial assets					
Trade and other receivables	14 & 17	-	10.4	29.3	39.7
Cash and cash deposits	19	-	264.9	-	264.9
Total		-	275.3	29.3	304.6
Financial liabilities					
Borrowings	22	-	(1,812.1)	-	(1,812.1)
Derivative financial instruments	18	(17.7)	-	-	(17.7)
Trade and other payables	20	-	(24.0)	(48.6)	(72.6)
Total		(17.7)	(1,836.1)	(48.6)	(1,902.4)

NOTES TO THE FINANCIAL STATEMENTS

13 Financial instruments by category (continued)

	Note	Fair value Derivatives £m	Amortised cost Loans and receivables £m	Trade receivables and trade payables £m	Total £m
31 March 2009					
Financial assets					
Trade and other receivables	14 & 17	-	14.5	24.0	38.5
Derivative financial instruments	18	0.2	-	-	0.2
Cash and cash deposits	19	-	251.7	-	251.7
Total		0.2	266.2	24.0	290.4
Financial liabilities					
Borrowings	22	-	(1,822.8)	-	(1,822.8)
Derivative financial instruments	18	(18.7)	-	-	(18.7)
Trade and other payables	20	-	(19.2)	(50.2)	(69.4)
Total		(18.7)	(1,842.0)	(50.2)	(1,910.9)

£17.6m (2009 £16.4m) of the derivative value above is used for hedging with £0.1m (2009 £2.1m) deemed as held for trading

14 Trade and other receivables non-current	2010 £m	2009 £m
Amounts owed by subsidiary company	<u>0.4</u>	<u>1.1</u>
The effective interest rate on amounts owed by subsidiary is 4.7% (2009 4.8%)		
15 Investments	2010 £m	2009 £m
Subsidiary undertakings	<u>3.3</u>	<u>3.3</u>
Joint venture	<u>0.1</u>	<u>0.1</u>

The Company has four wholly-owned subsidiaries, Peninsula Properties (Exeter) Limited, Peninsula Leasing Limited, South West Water Finance Plc and Haldon Collections 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%. The joint venture in Echo South West Limited ceased operations on 31 March 2008.

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

NOTES TO THE FINANCIAL STATEMENTS

16 Inventories	2010	2009
	£m	£m
Raw materials and consumables	<u>3.5</u>	<u>4.1</u>
17 Trade and other receivables – current	2010	2009
	£m	£m
Trade receivables	76.0	62.8
Less provision for impairment of receivables	<u>(46.6)</u>	<u>(38.8)</u>
Net trade receivables	29.4	24.0
Amounts owed by subsidiary companies	0.9	0.3
Amounts owed by fellow subsidiary companies	1.5	2.1
Amount owed by parent undertaking	1.0	1.0
Other receivables	6.5	10.0
Other prepayments and accrued income	<u>31.3</u>	<u>29.1</u>
	<u>70.6</u>	<u>66.5</u>

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

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. Its company policy is 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

	2010	2009
	£m	£m
Past due 0 – 30 days	9.0	8.4
Past due 31 – 120 days	9.7	7.7
Past due more than 120 days	<u>69.0</u>	<u>56.5</u>

The aged gross trade receivables above are taken directly from the Company's aged debt datamart before the deduction of credit balances and other adjustments. The figures are therefore higher than the trade receivables balance stated above in note 17.

The Company has a duty under legislation to continue to provide domestic customers with services regardless of payment. The Company 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

	2010 £m	2009 £m
At 1 April	38.8	32.4
Provision for receivables impairment	7.3	6.4
Amounts written-off during the period	(5.9)	(4.9)
Cumulative amounts previously excluded from debt	6.4	4.9
At 31 March	<u>46.6</u>	<u>38.8</u>

18 Derivative financial instruments

	2010 £m	2009 £m
<i>Interest rate swaps – cash flow hedges</i>		
Non-current assets	-	0.2
Non-current liabilities	(14.1)	(16.6)
Current liabilities	(3.5)	-
<i>Derivatives deemed held for trading</i>		
Current liabilities	(0.1)	(2.1)

The fair value of hedging derivatives is split between current and non-current assets or liabilities based on the maturity of the cashflows

The ineffective portion recognised in the income statement arising from cash flow hedges amounts to a gain of nil (2009 £0.4m)

Interest rate swaps and fixed rate borrowings are used to manage the mix of fixed and floating rates to ensure at least 50%, after the effect of interest rate swaps, of net borrowings is at fixed rate. At 31 March 2010 73% of net borrowings was at fixed rate (2009 62%)

At 31 March 2010 interest rate swaps to hedge financial liabilities with a notional principal value of £775.0m existed, with a weighted average to maturity of 4.4 years (2009 £540.0m, with 2.5 years) to swap from floating to fixed rate. The weighted average interest rate of the swaps was 4.0% (2009 4.8%)

The amounts above are the fair value of swaps based on the market value of equivalent instruments at the balance sheet date

In 2010 derivatives held for trading relate to interest rate swaps which no longer qualify for hedge accounting

The amounts above are the fair value of swaps based on the market value of equivalent instruments at the balance sheet date

NOTES TO THE FINANCIAL STATEMENTS

18 Derivative financial instruments (continued)

Valuation hierarchy

The table below shows the financial instruments carried at fair value by valuation method

	31 March 2010				31 March 2009			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
<i>Assets</i>								
Derivatives for hedging	-	-	-	-	-	0.2	-	0.2
Total Assets	-	-	-	-	-	0.2	-	0.2
<i>Liabilities</i>								
Derivatives for hedging	-	17.6	-	17.6	-	16.6	-	16.6
Derivatives held for trading	-	0.1	-	0.1	-	2.1	-	2.1
Total Liabilities	-	17.7	-	17.7	-	18.7	-	18.7

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities

Level 2 – Inputs (other than quoted prices included within level 1) that are observable for the asset and liability, either directly (that is, as prices) or indirectly (that is, derived from prices)

Level 3 – Inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs)

19 Cash and cash deposits

	2010 £m	2009 £m
Cash at bank and in hand	0.1	1.1
Overnight deposits	81.4	63.8
Other short-term deposits	150.2	170.2
Other deposits	33.2	16.6
	264.9	251.7

The effective interest rate on short-term deposits was 0.8% (2009 2.1%) and these deposits have an average maturity of 12 days (2009 23 days)

Other deposits include £33.2m (2009 £16.6m) 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

	2010 £m	2009 £m
Cash and cash deposits as above	264.9	251.7
Overdrafts (note 22)	<u>(17.3)</u>	<u>(17.0)</u>
	247.6	234.7
Less deposits with a maturity of three months or more	(33.2)	(16.6)
Cash and cash equivalents	<u>214.4</u>	<u>218.1</u>

20 Trade and other payables – current

	2010 £m	2009 £m
Trade payables	48.6	50.2
Amounts owed to subsidiary companies	2.9	1.6
Amounts owed to fellow subsidiaries	0.1	0.1
Other tax and social security	1.3	1.0
Other payables	0.8	0.8
Accruals	18.7	15.5
Deferred income	<u>0.2</u>	<u>0.2</u>
	<u>72.6</u>	<u>69.4</u>

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

21 Current tax liabilities

	2010 £m	2009 £m
Corporation tax	<u>51.9</u>	<u>23.2</u>

NOTES TO THE FINANCIAL STATEMENTS

22	Borrowings	2010 £m	2009 £m
	Current		
	Bank overdrafts	17.3	17 0
	Loan from subsidiary company	100.0	-
	European Investment Bank	14.1	14 1
		<u>131.4</u>	<u>31 1</u>
	Obligations under finance leases	23.9	24 2
		<u>155.3</u>	<u>55 3</u>
	Non-current		
	European Investment Bank	273.6	287 7
	Loan from subsidiary company	218.7	318 0
		<u>492.3</u>	<u>605 7</u>
	Obligations under finance leases	1,164.5	1,161 8
		<u>1,656.8</u>	<u>1,767 5</u>
	Total borrowings	<u>1,812.1</u>	<u>1,822 8</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

	2010		2009	
	Book value £m	Fair value £m	Book value £m	Fair Value £m
European Investment Bank	273.6	235.5	287 7	245 6
Loan from subsidiary company	218.7	189.8	318 0	249 6
	<u>492.3</u>	<u>425.3</u>	605 7	495 2
Obligations under finance leases	1,164.5	967.7	1,161 8	1044 8
	<u>1,656.8</u>	<u>1,393.0</u>	1,767 5	1,540 0

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

	2010 £m	2009 £m
6 months or less	840.5	748.4
6 – 12 months	642.9	758.2
1 – 5 years	121.6	224.8
Over 5 years	207.1	91.4
	<u>1,812.1</u>	<u>1,822.8</u>

The maturity of non-current borrowings was

	2010 £m	2009 £m
Between 1 and 2 years	37.1	147.7
Between 2 and 5 years	145.8	180.7
Over 5 years	1,473.9	1,439.1
	<u>1,656.8</u>	<u>1,767.5</u>

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

	2010 %	2009 %
Bank overdrafts	2.0	2.0
European Investment Bank	1.0	2.1
Finance leases	2.1	3.3
Loan from subsidiary company	4.7	1.3

Finance lease liabilities – minimum lease payments

	2010 £m	2009 £m
Within one year	38.5	54.9
In the second to fifth years inclusive	215.2	296.3
After five years	2,307.6	1,966.2
	<u>2,561.3</u>	<u>2,317.4</u>
Less future finance charges	<u>(1,372.9)</u>	<u>(1,131.3)</u>
	<u>1,188.4</u>	<u>1,186.1</u>

Included above are accrued finance charges arising on obligations under finance leases totalling £135.3m (2009 £136.0m), of which £11.9m (2009 £13.8m) is repayable within one year

Included above is £7.7m (2009 £14.6m) due to Peninsula Leasing Limited, a subsidiary company, under finance lease agreements of which £7.4m (2009 £7.2m) 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 2007 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 £24 0m at 31 March 2010 (2009 £16 6m) 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.

During 2010 the period for repayment of certain existing 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 deposit at 31 March 2010 of £9 2m is being held to settle the lease liability at the end of the lease term, subject to rights to release by negotiation with the lessor.

The Company has undrawn committed borrowing facilities

	2010 £m	2009 £m
Floating rate	-	-
Expiring within one year	-	-
Expiring after one year	<u>110.0</u>	<u>124 0</u>
	<u>110.0</u>	<u>124 0</u>

In addition, the Company has short-term uncommitted bank facilities of £60 0m (2009 £80 0m).

23 Other non-current liabilities

	2010 £m	2009 £m
Other creditors	<u>1.4</u>	<u>1 6</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

	2010 %	2009 %
Rate of increase in pensionable pay	4.10	3 75
Rate of increase for present and future pensions	3.60	2 75
Rate used to discount schemes' liabilities	5.53	6 50
Inflation	3.60	2 75

NOTES TO THE FINANCIAL STATEMENTS

24 Retirement benefit obligations (continued)

Assumptions regarding future mortality experience are set based on actuarial advice in accordance with published statistics and experience. The mortality assumption uses a scheme-specific 'medium cohort' basis.

The average life expectancy in years of a member having retired at age 62 on the balance sheet date is projected at

	2010	2009
Male	22.0	21.9
Female	25.4	25.4

The average life expectancy in years of a future pensioner retiring at age 62 twenty years after the balance sheet date is projected at

	2010	2009
Male	23.4	23.4
Female	26.6	26.5

The amounts recognised in the income statement were

	2010 £m	2009 £m
Current service cost	(6.5)	(6.8)
Past service cost	(1.2)	(1.6)
Total included within operating costs	<u>(7.7)</u>	<u>(8.4)</u>
Expected return on pension schemes' assets	15.0	17.8
Interest cost on retirement benefit obligations	<u>(17.5)</u>	<u>(18.8)</u>
Total included within net finance costs	<u>(2.5)</u>	<u>(1.0)</u>
Total charge	<u>(10.2)</u>	<u>(9.4)</u>

The actual return on schemes' assets was an increase of £56.5m (2009 decrease of £27.6m)

The amounts recognised in the statement of comprehensive income were

	2010 £m	2009 £m
Actuarial losses recognised in the year	<u>(32.8)</u>	<u>(50.6)</u>

The amounts recognised in the balance sheet were

	2010 £m	2009 £m
Fair value of schemes' assets	264.3	209.9
Present value of defined benefit obligations	<u>(347.6)</u>	<u>(261.3)</u>
Net liability recognised in the balance sheet	<u>(83.3)</u>	<u>(51.4)</u>

NOTES TO THE FINANCIAL STATEMENTS

24 Retirement benefit obligations (continued)

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

	Expected Return %	2010 Value £m	Fund %	Expected Return %	2009 Value £m	Fund %
Equities	8.5	161.8	61	8.8	126.8	60
Property / currency	9.0	16.5	6	7.9	7.7	4
Bonds	5.0	83.9	32	5.2	72.5	35
Other	4.5	2.1	1	8.8	2.9	1
		<u>264.3</u>	<u>100</u>		<u>209.9</u>	<u>100</u>

Asset values have been reanalysed to show other assets which principally represent cash contributions received from the company towards the year-end which are invested during the subsequent financial year

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 its investment advisers, the trustees have structured the schemes' assets with the objectives of balancing investment returns and levels of risk. The asset allocation has three main elements:

- holding of bonds which is expected to be less volatile than most other asset classes and reflects the schemes' liabilities
- a proportion of equities, with fund managers having 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 and international markets circa 50% each

Movements in the balance sheet liability were

	2010 £m	2009 £m
At 1 April	(51.4)	(21.7)
Income statement	(10.2)	(9.4)
Statement of recognised income and expenditure	(32.8)	(50.6)
Regular contributions	1.2	1.5
Other employer contributions	9.9	28.8
At 31 March	<u>(83.3)</u>	<u>(51.4)</u>

NOTES TO THE FINANCIAL STATEMENTS

24 Retirement benefit obligations (continued)

Movements in the fair value of schemes' assets were

	2010 £m	2009 £m
At 1 April	209.9	255.4
Expected return on schemes' assets	15.0	17.8
Actuarial gains/(losses)	41.5	(81.5)
Members' contributions	0.2	0.4
Benefits paid	(13.3)	(12.5)
Company regular contributions	1.1	1.5
Other Employer contributions	9.9	28.8
At 31 March	<u>264.3</u>	<u>209.9</u>

Movements in the present value of defined benefit obligations were

	2010 £m	2009 £m
At 1 April	(261.3)	(277.1)
Service costs	(7.7)	(8.4)
Interest cost	(17.5)	(18.8)
Members' contributions	(0.2)	(0.4)
Benefits paid	13.3	12.5
Actuarial (losses)/gains	(74.2)	30.9
At 31 March	<u>(347.6)</u>	<u>(261.3)</u>

The Company adopted IAS 19 from 1 April 2005 and the following historical data has been presented from that date

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Fair value of schemes' assets	264.3	209.9	255.4	285.5	266.7
Present value of defined benefit obligations	(347.6)	(261.3)	(277.1)	(320.0)	(301.7)
Net liability recognised	(83.3)	(51.4)	(21.7)	(34.5)	(35.0)
Experience (losses)/gains on schemes' assets					
Amount (£m)	41.7	(80.7)	(53.6)	3.2	33.7
Percentage of schemes' assets	15.8%	(38.4)%	(21.0)%	1.1%	12.6%
Experience losses/(gains) on defined benefit obligations					
Amount (£m)	2.8	18.3	(5.8)	(4.4)	(32.2)
Percentage of defined benefit obligations	0.8%	7.0%	(2.1)%	(1.4)%	(10.7)%

The Company's current service cost during the year was 16.4% of pensionable earnings (2009 16.4%) The Company's existing defined benefit schemes have been closed to new entrants from 1 April 2008

NOTES TO THE FINANCIAL STATEMENTS

24 Retirement benefit obligations (continued)

In 2008 the Pennon Group completed the triennial actuarial valuation of its defined benefit schemes as at 1 April 2007 which resulted in higher future service and deficit recovery contributions. The Group updated the valuation of the main scheme to 31 March 2009 and the Company has made deficit recovery contributions of £9.9m during the year (2009 £28.8m)

The Pennon Group monitors funding levels on an annual basis

25 Deferred tax liabilities

Deferred tax is calculated in full on temporary differences under the liability method using a tax rate of 28% (2009 28%)

The movements on the deferred tax account were

	2010 £m	2009 £m
At 1 April	316.9	300.0
Effect of abolition of industrial buildings allowance (Credited)/Charged to the income statement	-	19.1
Credited to equity	(14.2)	(13.9)
At 31 March	<u>302.6</u>	<u>316.9</u>

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

	Accelerated tax depreciation		Total £m
	Owned assets £m	Leased assets £m	
At 1 April 2008	295.5	15.5	311.0
Effect of abolition of industrial buildings allowance	19.1	-	19.1
Charged to the income statement	1.2	0.8	2.0
At 31 March 2009	<u>315.8</u>	<u>16.3</u>	<u>332.1</u>
Charged to the income statement	0.5	0.7	1.2
At 31 March 2010	<u>316.3</u>	<u>17.0</u>	<u>333.3</u>

NOTES TO THE FINANCIAL STATEMENTS

25 Deferred tax liabilities (continued)

Deferred tax assets	Provisions	Retirement benefit obligations	Other	Total
	£m	£m	£m	£m
At 1 April 2008	(1.6)	(6.0)	(3.4)	(11.0)
Charged to the income statement	1.2	5.9	2.6	9.7
Charged/(credited) to equity	-	(14.2)	0.3	(13.9)
At 31 March 2009	(0.4)	(14.3)	(0.5)	(15.2)
(Credited)/Charged to the income statement	(2.0)	0.2	0.5	(1.3)
Credited to equity	-	(9.2)	(5.0)	(14.2)
At 31 March 2010	(2.4)	(23.3)	(5.0)	(30.7)

	£m
Net deferred tax liability	
At 31 March 2009	<u>316.9</u>
At 31 March 2010	<u>302.6</u>

The deferred tax credited to equity during the year was

	2010 £m	2009 £m
Actuarial gains on defined benefit schemes	9.2	14.2
Hedging reserve	4.9	-
Share-based payments (note 28)	0.1	(0.3)
	<u>14.2</u>	<u>13.9</u>

26 Provisions for liabilities and charges

Restructuring	2010 £m	2009 £m
At 1 April	0.3	1.5
Charged to the income statement	5.0	5.0
Utilised during year	(2.2)	(6.2)
At 31 March	<u>3.1</u>	<u>0.3</u>

The provisions are all current

NOTES TO THE FINANCIAL STATEMENTS

27 Called-up share capital

	2010 £m	2009 £m
Authorised 500,000,000 Ordinary shares of £1 each	<u>500.0</u>	<u>500.0</u>
Allotted, called-up and fully paid 150,950,000 (2009 150,950,000) Ordinary shares of £1 each	<u>150.9</u>	<u>150.9</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	
		2010	2009
9 July 2002 189p	2005 – 2009	-	27
8 July 2003 177p	2006 – 2010	39	41
6 July 2004 200p	2007 – 2011	52	187
5 July 2005 270p	2008 – 2012	176	188
4 July 2006 358p	2009 – 2013	94	381
3 July 2007 522p	2010 – 2014	178	294
8 July 2008 517p	2011 – 2015	148	247
6 July 2009 386p	2012 - 2016	800	-
		<u>1,487</u>	<u>1,365</u>

At 31 March 2010 there were 767 participants in the Sharesave Scheme (2009 723)

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

	2010		2009	
	Number of Ordinary shares (thousands)	Weighted average exercise price per share p	Number of Ordinary shares (thousands)	Weighted average exercise price per share p
At 1 April	1,365	379	1,610	313
Granted	854	386	262	517
Exercised	(460)	289	(438)	221
Expired	(272)	492	(69)	353
At 31 March	<u>1,487</u>	<u>388</u>	<u>1,365</u>	<u>379</u>

The weighted average price at the date of exercise of Sharesave options during the year was 468p (2009 594p). The options outstanding at 31 March 2010 had a weighted average exercise price of 388p (2009 379p) and a weighted average remaining contractual life of 2.3 years (2009 1.8 years).

The aggregate fair value of options granted during the year was £0.9m (2009 £0.4m), determined using the Black-Scholes valuation model. The significant inputs into the valuation model were

	2010	2009
Weighted average share price	482p	646p
Weighted average exercise price	386p	517p
Expected volatility	29.0%	21.3%
Expected life	3.8 years	3.8 years
Risk-free rate	2.5%	4.9%
Expected dividend yield	4.7%	3.3%

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

NOTES TO THE FINANCIAL STATEMENTS

28 Employee share schemes (continued)

ii) Restricted Share Plan

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

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

	2010		2009	
	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	124	494	325	411
Vested	-	-	(96)	392
Lapsed	(124)	494	(105)	410
At 31 March	-	-	124	494

The plan was succeeded in 2007 by the Performance and Co-investment Plan

iii) Performance and Co-investment Plan

Executive Directors and senior management receive a conditional award of ordinary shares in the Company and are also required to hold a substantial personal 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.

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

	2010		2009	
	Number of ordinary shares (thousands)	Exercise price per Share p	Number of ordinary shares (thousands)	Exercise price per share p
At 1 April	233	598	112	557
Granted	160	487	121	638
At 31 March	393	553	233	598

NOTES TO THE FINANCIAL STATEMENTS

28 Employee share schemes (continued)

iii) Performance and Co-investment Plan (continued)

The awards outstanding at 31 March 2010 had a weighted average exercise price of 553p (2009 598p) and a remaining contractual life of 1.3 years (2009 1.9 years). The aggregate fair value of awards granted during the year was £0.5m (2009 £0.5 million), determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were

	2010	2009
Weighted average share price	486p	638p
Expected volatility	29.0%	21.3%
Risk-free rate	2.5%	4.9%

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

iv) Annual 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. 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.

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

	<u>2010</u>		<u>2009</u>	
	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	118	578	122	457
Granted	69	476	58	620
Vested	(41)	502	(62)	411
At 31 March	<u>146</u>	<u>551</u>	<u>118</u>	<u>578</u>

The awards outstanding at 31 March 2010 had a weighted average price of 551p (2009 578p) and a weighted average remaining contractual life of 1.6 years (2009 1.4 years). The Company's share price at the date of the awards ranged from 473p to 620p.

The aggregate fair value of awards granted during the year was £0.3m (2009 £0.4m), determined from market value. No option pricing methodology is applied since dividends declared on the shares are receivable by the participants in the scheme.

NOTES TO THE FINANCIAL STATEMENTS

29 Retained earnings and other reserves

	Hedging reserve	Retained earnings	Total
	£m	£m	£m
At 1 April 2008	2.6	40.6	43.2
Profit for the year	-	65.6	65.6
Other recognised income and expense for the year	(19.0)	(36.7)	(55.7)
Dividends paid	-	(103.8)	(103.8)
Share-based payments (net of tax)	-	1.0	1.0
Share options vesting (net of tax)	-	(0.6)	(0.6)
Reduction in share capital	-	300.0	300.0
At 31 March 2009	(16.4)	266.1	249.7
Profit for the year	-	96.8	96.8
Other recognised income and expense for the year	(1.2)	(18.7)	(19.9)
Dividends paid	-	(54.4)	(54.4)
Share-based payments (net of tax)	-	1.4	1.4
Share options vesting (net of tax)	-	(0.7)	(0.7)
At 31 March 2010	(17.6)	290.5	272.9

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

	2010 £m	2009 £m
Continuing operations		
Profit for the year	96.8	65.6
Adjustments for		
Employee share schemes	0.6	1.1
Deferred income released to profits	(0.2)	(0.2)
(Profit) on disposal of property, plant and equipment	(1.0)	(1.7)
Depreciation charge	93.6	89.8
Interest payable and similar charges	82.3	99.6
Interest receivable	(18.2)	(29.7)
Taxation	30.7	51.3
Changes in working capital		
Decrease in inventories	0.6	-
Increase in trade and other receivables	(6.2)	(9.1)
Increase/ (decrease) in trade and other payables	0.8	(12.0)
Decrease in retirement benefit obligations	(3.4)	(22.1)
Increase/(decrease) in provisions for liabilities and charges	2.8	(1.3)
Cash generated from operations	<u>279.2</u>	<u>231.3</u>

31 Net borrowings

	2010 £m	2009 £m
Cash and cash deposits	264.9	251.7
<i>Borrowings - current</i>		
Bank overdrafts	(17.3)	(17.0)
Other current borrowings	(114.1)	(14.1)
Finance lease obligations	(23.9)	(24.2)
Total current borrowings	<u>(155.3)</u>	<u>(55.3)</u>
<i>Borrowings - non current</i>		
Other non-current borrowings	(492.3)	(605.7)
Finance lease obligations	(1,164.5)	(1,161.8)
Total non-current borrowings	<u>(1,656.8)</u>	<u>(1,767.5)</u>
Total net borrowings	<u>(1,547.2)</u>	<u>(1,571.1)</u>

NOTES TO THE FINANCIAL STATEMENTS

32 Operating lease commitments – minimum lease payments

	2010 £m	2009 £m
Aggregate commitments under non-cancellable operating leases expiring		
Within one year	1.4	1.4
Later than one year and less than five years	5.2	5.3
After five years	19.2	20.4
	<u>25.8</u>	<u>27.1</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 27 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

	2010 £m	2009 £m
Contractors' claims on capital schemes	3.1	1.3
Guarantee of borrowings of subsidiary undertaking	300.0	300.0
	<u>303.1</u>	<u>301.3</u>

34 Capital commitments

	2010 £m	2009 £m
Contracted but not provided	<u>95.6</u>	<u>76.2</u>

35 Related party transactions

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

<u>Parent company</u>	2010 £m	2009 £m
Purchase of goods and services		
Group expenses	3.7	4.0
Sale of goods and services		
Administrative services	0.5	0.5
Loan interest received	-	1.6
Dividends paid	54.4	103.8

NOTES TO THE FINANCIAL STATEMENTS

35 Related party transactions (continued)

<u>Subsidiaries of the Company</u>	2010 £m	2009 £m
Purchase of goods and services		
Property consultancy	0.3	0.1
Payment for provision of finance		
Loan interest	10.8	12.7
Finance lease charges vehicles	0.1	0.1
Finance lease charges plant & machinery	0.3	1.5
Sale of goods and services (administrative services)	0.3	0.3
Loan interest received	0.1	0.1
 <u>Fellow subsidiaries of the Pennon Group</u>		
Purchase of goods and services		
Sludge tankering and waste disposal	0.7	0.6
Insurance premia	0.5	0.5
Sale of goods and services		
Tankered waste and trade effluent charges	0.9	0.7
 <u>Year end balances</u>		
Borrowings (note 22)		
Loan from subsidiary	318.7	318.0
Finance lease balances with subsidiary	7.7	14.6
Receivables (notes 14 and 17)		
Parent company	1.0	1.0
Subsidiaries	1.3	1.4
Fellow subsidiaries	1.5	2.1
Payables (note 20)		
Subsidiaries	2.9	1.6
Fellow subsidiaries	0.1	0.1

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.



SOUTH WEST WATER

SOUTH WEST WATER FINANCE PLC

Peninsula House, Rydon Lane, Exeter EX2 7HR Tel 01392 446688 southwestwater.co.uk

A meeting of the **BOARD OF DIRECTORS** of **SOUTH WEST WATER FINANCE PLC** will be held in the Board Room at Peninsula House, Rydon Lane, Exeter on Friday 25 June 2010 at 10 00 a m

A G E N D A

- 1 APOLOGIES**
- 2 DECLARATIONS OF INTEREST**
- 3 ANNUAL REPORT AND FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010**

To consider the report of the Finance Director and request approval of the Annual Report and Financial Statements For the year ended 31 March 2010
- 4 PUT BOND - AMENDED AND RESTATED TRUST DEED**

Approval and ratification of the Amended and Restated Global Note and the Exchange of Global Note Instruction letter (as executed by South West Water Finance Plc on 15 June 2010)
- 5 ANY OTHER BUSINESS**

K D Woodier
Company Secretary

24 June 2010



INVESTOR IN PEOPLE

South West Water Limited Registered in England No 2366665

A subsidiary of Pennon Group Plc Registered Office Peninsula House Rydon Lane Exeter EX2 7HR