

# SOUTH WEST WATER LIMITED

## ANNUAL REPORT AND FINANCIAL STATEMENTS 2012



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# ANNUAL REPORT AND FINANCIAL STATEMENTS 2012

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## **CHIEF EXECUTIVE'S REVIEW**

### **Year in Review**

South West Water's 2011/12 performance has placed us in a strong, confident and profitable position. Operational excellence, our best ever leakage control results, best ever drinking water quality and record bathing water standards are testament to the company's continued drive for industry-leading performance and forward-thinking investment. Similarly, South West Water's ability to effectively manage water resources has been highlighted by a fifteenth consecutive summer without water restrictions in 2011 and a sixteenth anticipated in 2012 – a welcome reassurance to our customers particularly at a time of national headline-hitting water resource issues.

The company's focus on resources and resilience remains paramount and South West Water continues to look at innovative ways to maximise the yield of its assets. Having recently become operational as reservoirs, our two former china clay pits – Park and Stannon – ensured that we had new reserves to draw on during 2011 and 2012. Coupled with our use of pumped storage schemes during the winter months, the strategic acquisition of these sites has clearly been important.

Within South West Water's programme of capital investment 2011/12 has seen the company successfully deliver a number of high value projects including refurbishments to our water treatment works at Tottiford in Devon and Drift in Cornwall. The construction of a new service reservoir at Coswarth near Newquay is supporting the provision of water for more than 9,000 households. Meanwhile, investment in the new borehole at Greatwell in East Devon has secured further supplies for the region.

On 1 October 2011 the ownership of private sewers in England and Wales was transferred to water and sewerage companies. This increased South West Water's sewer network by over fifty percent. Detailed preparations ensured that this new responsibility quickly became part of 'business as usual' and was effectively communicated to our customer base. Subsequent operational activity has been within the expected levels and shareholders are expected to receive an appropriate return for expenditure incurred through regulatory mechanisms.

From a sustainability perspective, 2011/12 has been a year of continued investment in environmental projects and initiatives. In addition to the refurbishment of a number of waste water treatment works, South West Water has successfully trialled grit and screenings composting to lessen our ecological impact by reducing the amount of waste we send to landfill. We have also expanded our use of renewable energy through solar, wind and hydro power schemes at more than twenty sites and we continue to promote in-house energy efficiency.

The number of bathing waters in our region now hitting the EU's highest standard is at an all-time high and South West Water continues to strive for excellence in this regard. Integral to the region's economy and quality of life, our coastal environment must be protected and we are working towards this shared goal with a number of partner agencies and organisations.

Similarly, South West Water has forged ahead with its flagship 'Upstream Thinking' project. During 2011/12 we expanded our work with landowners and the agricultural community to enhance and maintain the quality of our river network in rural areas. The company is now working with 495 landowners. Meanwhile, alongside researchers from the region's universities, South West Water has also continued to implement and monitor our Exmoor and Dartmoor based programmes of peat bog restoration. Designed to improve the quality and natural storage of the raw water supply, these also serve to reduce carbon emissions and restore natural habitats.

Across the business South West Water looks to minimise its environmental impact. Whilst the total number of pollution incidents is reducing, in 2011/12 there were 16 serious pollution incidents. In each case corrective action was taken as quickly as possible, investigations were conducted in cooperation with the Environment Agency and steps were identified to prevent a repeat incident.

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

Customer engagement is integral to our business and 2011/12 has seen South West Water successfully move into new territory in how we meet the demand for information, advice and assistance both from households and businesses

In October 2011 we introduced our specialist 'Source for Business' service to provide extra support for commercial customers. Meanwhile, in response to the exponential growth in online communications we have launched online accounts, a smartphone app and web-based information services including Beachlive (which provides real-time information on bathing water quality) and Waterlive (which keeps customers updated on operational incidents). Each of these highlight our desire to be both transparent and accountable.

South West Water's emphasis on excellent customer service has been reflected in the company achieving a 15% improvement in customer service as measured by Ofwat's Service Incentive Mechanism (SIM) score (and a 78% improvement over two years).

Customer complaints have continued to fall since March 2011, with a 25% reduction in the number of written complaints. This figure has halved over the last two years.

In its 'Water for Life' White Paper the Government announced an annual £50 water bill reduction for households in the South West. South West Water has welcomed the proposal which is intended as compensation for the "historic unfairness" of above average bills. A result of the post-privatisation investment needed to modernise our sewerage system, this has long been a sensitive regional issue and one that we have proactively sought to resolve.

As one of the largest employers in the region, South West Water is a key player in the local economy and we remain committed to nurturing fresh talent for the future. In the last twelve months our apprenticeship scheme has gathered momentum and our strategic investment in both people and technology - in the form of our centrally operated remote PUROS (Phased Utilisation of Remote Operating Systems) system and other innovations - means we are reaping the rewards of increased productivity delivered by a highly trained and motivated workforce.

South West Water's robust operational performance has been underpinned by strong financial results with the company outperforming Ofwat's targeted operating cost reductions.

The company is front-end loading the delivery of our required 2.8% per annum average operating cost efficiencies with 5.1% per annum delivered in the first two years of the K5 period (2010-2015). This is being achieved through changing operational ways of working, rightsourcing and innovative contracting arrangements, energy procurement and reduced usage, and the rationalising of administration and support services.

Capital expenditure for the K5 period to date is favourable compared with the Capital Incentive Scheme (CIS) baseline and is targeted to achieve 5%<sup>(1)</sup> outperformance of the Final Determination. With its increased emphasis on the maintenance of existing assets, South West Water continues to deliver the required capital project outputs, with stable serviceability<sup>(2)</sup> maintained for all service areas.

The focus for K5 is to continue to strike the right balance for customers, investors and other stakeholders. The company has delivered substantial efficiencies which benefit all stakeholders and is focusing on continued delivery of efficiency whilst satisfying its regulatory and legislative obligations and improving services to customers. The South West Water strategy

- targets outperformance of the regulatory contract
- continues to rigorously control costs

## CHIEF EXECUTIVE'S REVIEW (continued)

- delivers investment in the asset base that will secure operating cost savings and protect the service and environmental improvements made over the last twenty plus years whilst preparing for the next

The company is working towards the next Price Review (PR14) and is actively engaged in the development of Ofwat's regulatory agenda. We have already rolled out our initial phases of customer engagement and work is underway to determine investment scenarios for the next period.

In every sphere of the business, South West Water has continued to strive for improvement. While we recognise that there are targets still to be met we feel very proud of our successes in 2011/12. To this end I would like to extend my thanks and appreciation to all of our employees for their valued commitment and hard work.



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

<sup>(1)</sup> Using 2009 Final Determination estimates of Construction Output Price Index (COPI)

<sup>(2)</sup> 'Serviceability' is the capability of a system of assets to deliver a reference level of service to customers and to the environment now and into the future. Serviceability is deemed to be stable when the assessment of trends in a defined set of service and asset performance indicators demonstrates that service is in line with the reference level of service and, by inference, is likely to remain so into the future.

## REPORT OF THE DIRECTORS

An increase in turnover and good operational cost control has resulted in South West Water's operating profit increasing by £15.0m to £204.7m

South West Water's revenues rose 5.7% to £474.7m as a result of tariff increases, new connections offset by an anticipated overall reduction in demand and the effects of customers switching to a meter

Approved tariff increases, including the 3.4% K factor, amounted to £36.4m. Customers switching from unmeasured to metered charging reduced revenue by £7.2m, but 6,005 new customer connections contributed £2.8m of additional revenue. Customer demand has fallen in line with expectations by 2.6% on the same period last year, impacted by general economic conditions

16,381 (2011: 14,198) customers benefited from lower bills saving of on average £464 (2011: £423) by choosing to switch to a metered supply. As a result 73.4% of South West Water's domestic customers are now metered (2011: 70.9%)

Operating costs, including depreciation, increased from £259.4m to £270.0m. Good operational cost control has been achieved in a high inflation environment with cost increases of £6.7m being below the 4.8% average inflation for the financial year, offset by £6.7m of efficiencies delivered in the year. Other cost drivers were

- costs from new capital schemes of £7.4m (£3.5m of depreciation and additional asset maintenance costs of
- £3.9m relating to the increased emphasis on maintenance in the investment programme)
- the adoption of private sewers from 1 October 2011 resulting in increased operating costs of £2.5m
- cost changes of £1.9m predominantly as a result of lower property sales and the introduction of the Government's Carbon Reduction Commitment (CRC) levy

Bad debt charges, equivalent to 1.8% of revenue are marginally higher than last year, but improved towards the end of the year reflecting improved collection initiatives

The depreciation charges increased by £3.5m from £97.0m to £100.5m, reflecting the impact of the company's capital expenditure programme

The company's restructuring programme continued in the year with £2.5m charged to the income statement (2010/11: £4.0m)

Profit on property and equipment disposals in the year contributed £1.1m compared to £1.6m in 2010/11, reflecting the economic conditions in the property market

The charge for bad and doubtful debts increased in the year by £0.6m from £7.9m to £8.5m. During the year £6.6m (2010/11: £7.2m) of debts were written off against the provision, of which £2.2m relates to personal and commercial bankruptcy and £0.9m (2010/11: £1.0m) related to the company's Restart programme, a customer affordability initiative

### Investment

Capital additions in the year were £130.8m compared to £125.1m in 2010/11

The emphasis of the company's capital programme for K5 is on maintenance with 70% of the spend for 2011/12 in this area

## REPORT OF THE DIRECTORS (continued)

Key areas of focus remain

- water resources and ensuring the resilience of our networks
- improved drinking water quality
- delivering environmental improvements

### Serviceability

Serviceability is used to measure the performance of assets in delivering services to our customers and protecting the environment

It is assessed using individual sets of measures for each of our asset groups, water treatment, water mains, waste water treatment and sewers

South West Water's goal is to maintain the high levels of service that we deliver to our customers and the environment, by maintaining 'stable serviceability' This was ensured during 2011 through targeted investment in our capital maintenance programmes

South West Water's capital expenditure is allocated between the water and waste water activities

£62.0m was invested in water supply improvements including water mains renovation and water treatment works enhancement

Investments made during the year included upgrading filtration and the refurbishment of Tottiford (Devon) and Drift (Cornwall) water treatment works, construction of a new service reservoir and 111km of mains renovation and replacements

Strategic investment in new resources, including the ongoing development of a new borehole in Devon, has resulted in this year being our 15th consecutive year without water restrictions. Through the continued effective management of our resource position no water restrictions are envisaged in summer 2012 at this stage.

Capital investment in the year for the waste water business totalled £68.8m

Asset enhancements and maintenance have been a focus for the year with significant upgrades at three waste water treatment works and sewer rehabilitation. In addition South West Water has targeted a number of properties that had been incorrectly connected to the surface water drainage system or not connected to the sewerage system.

The adoption of private sewers resulted in £0.7m of capital maintenance costs. The emphasis of spend has been on maintenance and minor enhancements. The capital programme of enhancements is being finalised, focusing on those areas which have the greatest impact on our customers.

Expenditure on PUROS was £8.9m. The PUROS programme is a key contributor to support the company's strategy of delivering Pure Water, Pure Service and Pure Environment by aiming to contribute sustainable cost reductions and better service through the delivery of

- remote management of networks and assets
- a flexible, mobile enabled, multi-skilled workforce
- central control of people, assets and information

South West Water has invested £4.4m in energy generation schemes using solar, wind and hydro power.

## REPORT OF THE DIRECTORS (continued)

### Financing

Net interest payable increased by £2.4m from £60.9m to £63.3m. While the company gained from the continued low LIBOR rates, interest charges on the index-linked lease have increased due to higher Retail Prices Index (RPI). An innovative financing arrangement resulted in a net £1.7m increase in interest receivable and net pension income was £1.6m.

Net debt increased from £1,542.8m to £1,584.9m. The outflow reflects higher capital expenditure, £26.3m of pension deficit payments, and an increase in dividend payments resulting from the payment of the 2010/11 outperformance in September 2011.

Pennon Group and South West Water have robust treasury policies in place. These include policies requiring 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.

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

Short term committed credit facilities in place at 31 March 2012 and undrawn totalled £140.0m (2011 £120.0m). In addition the company has short-term uncommitted bank facilities of £50.0m (2011 £60.0m).

South West Water has approximately 24% of its debt index-linked.

Derivatives, usually interest rate swaps, are used to manage the mix of fixed and floating rate debt, following the Pennon Group treasury policy that at least 50% of South West Water's debt is fixed for a regulatory period. 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 net derivative liabilities moved from £17.4m to £43.2m at 31 March 2012. The movement is taken to reserves through the Statement of Comprehensive Income.

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.

The financial covenants included in the company's debt facilities are monitored on a regular basis. 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.

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 2012 amounted to £2,826.8m, which represents an increase of 4.6% in the year.

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

South West Water's net debt to RCV was 56.1% at 31 March 2012 (2011: 57.1%), within Ofwat's 'optimum range' of 55% - 65%

Regulatory interest cover for 2011/12 was 2.1 and well within the required levels for financial covenants and in line with expectations

The Board regularly monitors the company's expected financial requirements for the next twelve months. These will be met from existing cash balances, loan facilities and cashflows 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 economic conditions.

### **Going concern**

Having considered the company's solvency and liquidity risk profile, and in particular the financial position and 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.

### **Taxation**

The overall tax charge for the year increased by £8.2m from £3.7m to £11.9m.

Within the tax charge the current corporation tax charge increased by £4.0m, from £23.7m to £27.7m, reflecting the increase in profit offset by the decrease in corporate tax rates to 26%.

Deferred tax for the year was a credit of £15.8m (2010/11: credit £20.0m). The deferred tax credit is net of a credit of £21.5m from the impact of the reduction in the rate of corporation tax for future years. This will continue to change as corporation tax rates change.

### **Dividends and reserves**

Following consideration of future cash flow and balance sheet requirements, dividends totalling £77.9m (2010/11: £58.4m) were paid to the parent undertaking, representing a base dividend for 2011/12 of £62.9m and £15.0m of outperformance for the 2010/11 financial year. The dividend was calculated with reference to the projections in the Ofwat 2009 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 outperformance
- consistency with the assumptions made by Ofwat in setting prices for the K5 period

Taking into account balance sheet considerations, dividend payments are also 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)**

### **Pure Water**

#### **Drinking water quality**

South West Water prides itself on achieving industry leading water quality results. In 2011, the quality of our water, as measured by Mean Zonal Compliance, was near perfect.

The continued high standards of our drinking water can be directly attributed to our ongoing investment and innovation in our treatment processes, driven by our 'source to tap' water safety plan. In addition, our water quality has benefited from a rigorous mains improvement programme, improvements in maintenance performance and the implementation of a taste and odour improvement strategy.

#### **Leakage control**

In 2011/12 we successfully surpassed our previous record to achieve a record low of 81.3 Megalitres lost on average per day over a twelve month period. We have achieved or beaten our leakage targets every year since they were first introduced 15 years ago.

Against the backdrop of a milder winter the strong performance this year has been due to a number of combined factors:

##### *Early detection*

The predominantly dry weather and mild winter was beneficial for leak detection as the reduced number of repairs in progress meant that we could identify potential leaks or bursts more easily. Our systems of monitoring also greatly benefited from the swift response of our repair and maintenance partner.

##### *Investment in technology*

During the last few months of the year the use of South West Water's new PUROS mobile working system had a positive impact on managing leakage. Our leak detection inspectors now have their work dispatched to them in the field via Personal Digital Assistants (PDAs) through which details of leaks can be fed back to the central control room. This enhanced method of communication has reduced the amount of time taken to process leaks by almost two days.

##### *Communication with customers*

Our on and offline systems for reporting potential leaks continue to ensure that customers are able to easily and quickly provide us with information on leaks and bursts.

##### *Pressure management*

South West Water is undertaking a pressure management programme. This improves the reliability of the clean water distribution network, particularly in those areas which experience high pressure and a high frequency of bursts.

#### **Water resources**

Despite below average rainfall in winter and spring in early 2011, South West Water was able to avoid putting water restrictions in place for a fifteenth consecutive summer.

This was achieved, primarily, as a result of strategic investment in expanding our reservoir system and distribution network. Now fully operational, Park and Stannon lakes in Cornwall played a key role in ensuring resources were maintained during 2011/12. Formerly china clay pits, the two sites were acquired in 2006 and 2008 respectively with Stannon lake now Cornwall's second largest reservoir.

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

As existing bodies of water, the investment in Park and Stannon lakes was highly cost effective and our innovative use of these sites is a key aspect of our strategy to ensure a secure supply for the region. In addition, South West Water also made use of pumped storage schemes at Wimbleball, Stithians and Colliford reservoirs during winter 2011/12. This involves abstracting water from rivers while levels are healthy in order to supplement the natural inflow to reservoirs.

South West Water's resource network has been further expanded in the past year, most notably through the addition of the following:

- Coswath service reservoir, near Newquay, Cornwall (to support water supplies to more than 9,000 homes)
- development of Greatwell Borehole, East Devon (South West Water's first new borehole in 18 years)

### **Our 2012 position**

The national concerns over drought in 2012 serve to highlight the importance of efficient water use. South West Water is committed to a strategy that maximises the yield of resources and assets and we continue to raise awareness with our customers about how to use water wisely.

Based on our current position we are confident of a sixteenth consecutive summer without water restrictions. As would be expected, South West Water is monitoring the situation and will make the best use of its resources accordingly.

### **Future resources and resilience**

The future provision of safe and reliable water supplies will depend on how well companies respond to, and prepare for, the implications of factors such as climate change, competition and changes to environmental legislation and standards.

South West Water's strategy is designed, first and foremost, to ensure that the company is making the most efficient use of existing resources. Our industry-leading levels of leakage are complemented by our work to promote water efficiency within our customer base, thereby targeting a healthy balance between supply and demand.

Furthermore, South West Water takes proactive steps to encourage sustainable development. The company continues to invest in infrastructure enhancements, building links between resource zones to optimise the efficiency of the network and developing new resources for the future as and when appropriate.

## **Pure Service**

### **Customer satisfaction**

At the core of South West Water's 'Pure Service' strategy are the needs of our customers. Since 2010/11, customer service has been measured by Ofwat's Service Incentive Mechanism (SIM). This takes into account a number of aspects including the number of written complaints and the results of customer satisfaction surveys.

South West Water achieved a 15% improvement in customer service between 2010/11 and 2011/12 based on its SIM score (2010/11 58.1, 2011/12 66.9). This contributes to a 78% improvement over two years.

Customer complaints have continued to fall since March 2011, with a 25% reduction in the number of written complaints.

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

The number of written complaints has halved in the last two years and the results of customer satisfaction surveys, which form part of the SIM performance, have improved from last year (2010/11 4 0, 2011/12 4 1)

South West Water continues to look at ways to further enhance our levels of service. Within our call centre we have taken steps to deal with complex issues more quickly, thereby reducing the likelihood of a complaint escalating. This includes the training of expert staff to deal with such matters. In addition, we are set to roll out an enhanced Customer Relationship Management

(CRM) system in the coming year to ensure that when a problem cannot be solved at the first point of contact we have a more thorough process of seeing it through to resolution.

We are also driving higher levels of customer satisfaction using online platforms. This includes the launch of online accounts, a smartphone app and web-based information services including Beachlive (which provides real-time information on bathing water quality) and Waterlive (which keeps customers updated on operational incidents).

### **Supply interruptions**

South West Water is committed to providing safe, clean and high quality water to our customers. However, on occasion, interruptions to supply do occur due to operational events or essential maintenance on our network. The average interruption to supply for our customers in 2011/12 was 0 62 hours per property connected, over 50% of which was due to planned maintenance.

### **Private sewers**

On 1 October 2011, the Government transferred the ownership of the majority of private sewers to water and sewerage companies.

The sewer network for South West Water increased by over fifty percent. This had a knock-on benefit for the majority of customers who are no longer at risk of high sewer maintenance costs and are now only responsible for the drains located within and serving their properties.

Customers were informed of the transfer by letter during July 2011 and this was supported by a dedicated call centre which received approximately 3,000 calls (representing 0 43% of customers) during July and August. Further information was posted on the company's website including films explaining the transfer and an extensive frequently asked questions section.

South West Water is continuing to evaluate the impact of the private sewer transfer. We are confident that our smooth transition into the new role was the result of careful planning, an effective communications strategy and efficient activity on an operational level.

Plans are currently being developed to ensure a targeted approach to future investment, identifying those areas that have the largest impact on our customers.

### **Internal sewer flooding**

Internal flooding of properties is regrettable and extremely unpleasant for customers. South West Water continues to strive to reduce the number of customers at risk of flooding and thus reduce the number of repeat incidents that occur. 31 of the properties flooded during the year had previously been flooded within the last 10 years.

### **Government Legislation: £50 bill reduction for South West Water Customers**

Since privatisation in 1989 South West Water customers have effectively been paying for the protection and upkeep of a third of the nation's bathing waters. Highlighted in the 2009 Walker Review and pursued vigorously by South West Water alongside regional MPs, consumer groups and media organisations, this sensitive regional issue was addressed in December 2011 with the publication of

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

the 'Water for Life' White Paper This included a Government pledge to reduce household bills in the region by £50 per year from 2013/14 The legislation was formally passed on 1 May 2012 and came into force on 1 July 2012 Customers will receive a £50 credit on their bills from April 2013

### **Affordability**

South West Water continues to consult with regulators, customers and stakeholder groups on the issue of affordability

It is our aim to treat customers appropriately to their circumstances and we offer a number of initiatives to assist those struggling to pay their bills

These include

- WaterCare+ – free service which includes household water use audit and benefit analysis
- Restart scheme – helping nearly 8,000 customers to reduce their debt by incentivising them towards a pattern of regular payments
- instalment-based payment plans
- WaterSure tariff – for those in receipt of means-tested benefit or tax credit
- training and administration resource for Citizens Advice Bureau staff
- Fresh Start Fund – managed by an independent board for one-off hardship cases

### **Water efficiency**

Efficient water use is something South West Water looks to promote wherever and whenever possible

We offer our customers the following services

- freephone water conservation helpline
- online information
- water audits
- educational materials and school talks
- discounted water butts for the region's gardeners

### **Business customers**

In 2011, South West Water launched Source for Business, a dedicated service that provides advice and assistance for commercial customers on a range of water, sewerage and environmental matters

The Source for Business services include

- bill validation
- effluent and process management
- laboratory and analytical services
- water and carbon efficiency advice
- advice on capital solutions
- project management through design and build to operation and maintenance

In addition 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

## REPORT OF THE DIRECTORS (continued)

### Pure Environment

#### Coastal waters

The quality of beaches and bathing waters in the South West plays an integral role in the region's economy, culture and lifestyle

With 144 designated bathing waters punctuating more than five hundred miles of coastline, South West Water has a potential impact on more coastal waters than any other water company in England or Wales

The 2011 bathing season ended with our best ever bathing water results with 137 out of 144 bathing waters (95.1%) achieving European 'guideline' standard (excellent status) 142 (98.6%) achieved European 'mandatory' standard (good status) compared with 139 (96.5%) in the 2010 bathing season

South West Water's success in bathing water quality can be attributed to our £2 billion Clean Sweep programme which has seen 250 raw sewage outfalls closed down and more than 140 complementary projects delivered in the last two decades

#### Waste water treatment

In the 2011 calendar year our performance on Population Equivalent Sanitary Compliance was 99.57% (2010 99.55%) This measure refers to the percentage of the population whose waste is treated at waste water treatment works that meet the required standards This high level of compliance is because only a very small number of our smaller waste water treatment works have not met the standard, and any impact on river or coastal water quality has therefore been minimal

Our strong performance on Population Equivalent Sanitary Compliance ensures that the very high quality of the aquatic environment is protected for the benefit of customers, visitors and other stakeholders This consistently high performance is also within the reference levels used by Ofwat to assess 'stable serviceability' for waste water treatment works

Numeric compliance of waste water treatment works is another measure that looks at a much wider range of compliance parameters than those used in population equivalent sanitary compliance Measuring compliance by number of works gives equal weighting to all works from our smallest to our largest Again, our performance is within the reference levels used by Ofwat to assess 'stable serviceability' for waste water treatment works

Whilst we have maintained our performance and achieved stable serviceability, we are committed to improving compliance at our waste water treatment works We have prepared a targeted investment strategy, through consultation with the Environment Agency, to further increase compliance This will derive further environmental benefits for the region

#### Upstream Thinking

South West Water's 'Upstream Thinking' strategy aims to improve raw water quality and control water treatment costs This approach offers more sustainable management of climate change impacts by addressing risks and challenges at source, instead of incurring the additional capital and operating costs of more intensive water treatment Benefits will also include a lower carbon footprint through reduced use of both energy and chemicals

Within the price limits set for 2010 to 2015, Ofwat has supported this approach by enabling c £9million to be spent during this period

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

At the end of 2011/12 c £3million has been incurred on the following activities

- 237 hectares of land restored (moorland and Culm grassland)
- working with 495 farms across catchments, supporting infrastructure investments on 96 farms
- scientific equipment installed to monitor the impacts of restoration
- studies completed to inform future investment options

Our plan for the remainder of K5 will enable the delivery of the Upstream Thinking project to be delivered in line with the Final Determination

We were delighted that the Upstream Thinking programme was the winner of the 'Partnership Initiative of the Year' category at the Water Industry Achievement Awards in March 2012 Upstream Thinking won the 'Partnership Initiative of the Year' category at the Water Industry Achievement Awards, March 2012 It also earned South West Water the Large Business category at the Finance for the Future Awards 2012 These recognise financial leaders driving business sustainability

### **Renewable energy**

To combat climate change, reduce our carbon footprint and lower our energy costs, South West Water recognises that renewable energy has an important role to play

In 2011/12 our investment in renewable energy included the installation of solar panels at twenty-three of our sites (nineteen 50kW schemes and four 100kW schemes) and the development of hydroelectric schemes at Colliford Dam and Bratton Flemming water treatment works

At Lowermoor water treatment works in North Cornwall we erected a single 100kW wind turbine in order to similarly improve energy efficiency This is set to generate around 280MWh – approximately 60% of the site's power needs

Our goal is to ensure that 30GWh of the energy we use is generated from renewable sources by 2015 Ultimately South West Water aims to source 50% of its energy from renewables by 2050

### **Carbon reduction**

South West Water is committed to reducing its carbon footprint and has a number of initiatives in place to reduce energy usage and increase renewable energy generation All of these factors will assist in a reduction of greenhouse gas emissions In 2011/12 South West Water recorded emissions of 152.7 ktCO<sub>2</sub>e, down from 155.9 in 2010/11

South West Water is committed to a 34% reduction in carbon emissions by 2020 and an 80% reduction by 2050 (on our 2006/07 baseline) as per the national framework

Our emissions reduction plan covers a range of operational activities and initiatives including

- pump efficiency
- Powerdown (in-house initiative)
- PUROS (energy-saving through centrally operated remote systems)
- water efficiency
- asset optimisation

In 2011/12, South West Water's carbon emission levels were higher than expected although there was an overall reduction on the previous year Prolonged periods of dry weather meant an increased energy need for pumping, however the overall reduction highlighted the positive impact our energy efficiency projects and renewable energy schemes are having

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

### **Pollution control**

Since 1999, all substantiated pollution incidents in England and Wales have been classified into four categories in order of the severity of their impact on the water environment 1 (major), 2 (serious), 3 (minor) and 4 (no impact)

In 2011, South West Water achieved a ten-year low in the total number of Category 1 to 4 pollution incidents. This has been achieved as a result of investment in our sewerage and sewage treatment systems and improvements in our operation and maintenance of them.

The majority of our sewerage network, as for all sewerage companies, comprises a combined system which includes surface water as well as foul. High levels of rainfall can overload the system, which then requires overflows to operate in order to protect properties from flooding. South West Water has progressively added storage tanks to our sewerage network to reduce spills, and the resultant risk of pollutions, from these overflows. We are therefore maximising flows to waste water treatment works, to ensure that, except in very heavy rainfall, all flows are treated to very high standards. For bathing waters there should be on average no more than three spills per bathing season (May to October) and for shellfish waters, no more than ten spills per annum.

Significant efforts are also being made to reduce the number of pollution incidents through planned capital maintenance investment schemes targeting key assets to improve their reliability of these assets and reduce the risk of failure and pollution.

In 2011 the total included one Category 1 and fifteen Category 2 incidents. This compares with one Category 1 and five Category 2 incidents in 2010.

The single Category 1 incident involved a pumping station where proactive work was already underway to refurbish the systems in place.

The majority of the Category 2 incidents (11 of 15) in 2011 were from problems either at overflows or on the sewerage network, mostly relating to blockages or sewer collapses. South

West Water will be increasing its sewer cleaning, maintenance activities and speed of response to blockages in 2012/13 to ensure that the number of these events is reduced.

Many of the incidents reported only occurred for short periods of time and none of them resulted in any long term harm to the environment. The quality of the significant majority of both rivers and bathing waters in the South West region therefore remains high and represent some of the best in the country, and indeed Europe.

When incidents do occur we have strict procedures in place to ensure the appropriate action is taken and that they are reported to the relevant authorities in an accurate and transparent manner. After each incident, the company takes such steps as are necessary to ensure that the incident will not be repeated and also seeks to ensure that the lessons learned are widely disseminated throughout the company.

### **Community, corporate responsibility and sponsorship**

South West Water is actively involved with local community projects, including educational schemes co-ordinated in partnership with local schools, colleges and universities. The company 'caravan' regularly attends public events and South West Water continues to sponsor a number of community-focused initiatives under the themes of youth, water and environment. In addition, we opened three sites to the public in September 2011 as part of the Heritage Open Days initiative.

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

In November members of the public enjoyed guided tours of the new waste water treatment works serving the communities of Boscastle, Bossiney and Tintagel in Cornwall. The tours, hosted by South West Water, gave local residents and two primary schools unique behind-the-scenes access to the state-of-the-art facility.

We are committed to being a good neighbour and a trusted partner in the communities we serve. Our annual community sponsorship supports community projects and organisations which are linked to water, benefit the environment or promote youth participation. During 2011/12 £79,856 was allocated to a wide range of projects across the region. Apart from this sponsorship, no charitable donations were made in the year (2010/11 £nil).

South West Water is developing a programme of employee volunteering to engage with local communities. This includes working with schools, with employees educating children about the water cycle and WaterAid. Other employees will visit Exmoor to help maintain the dam structures which have been put in place as part of the Mires restoration project.

During 2011/12 our educational support included

- providing work experience placements to school and university students
- five gap-year student placements offered as part of the 'Year in Industry' programme
- sponsorship for STEM (Science, Technology, Engineering and Maths) days in partnership with The Smallpiece Trust
- delivering lectures on Operational Management and Customer Service at the University of Bristol for its MSc Water & Environmental Management students
- the provision of educational materials to local schools, including science experiments to demonstrate the water cycle to primary school children

## **People and Stakeholders**

### **Our employees**

South West Water prides itself on being a responsible employer, attaching paramount value to the safety, training, needs and ambitions of its employees.

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.

### **Health and safety**

South West Water's Occupational Health and Safety strategy focuses on providing strong leadership, engagement with employees, building competencies and measuring performance. These principles are promoted by a health and safety steering group comprising a cross-section of directors, managers and employee representatives. A number of audits are carried out each year and the company continues to promote in-house safety campaigns such as 'TAP' (Think, Act, Prevent).

The campaign is a three year behavioural safety programme that recognises the importance of human behaviours in relation to health and safety. It has been introduced to help in the development of a positive health and safety culture.

RIDDOR (Reporting of Injuries, Diseases and Dangerous Occurrences) incidents per 1,000 employees totalled 16 in 2011 compared to 20 in 2010.

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

### **Training and support**

Thorough training and support are provided with opportunities for staff to develop their careers through a number of schemes. These include our internal Graduate Development Programme ('GROW') and our Management Academy which is designed to advance business knowledge, enhance personal effectiveness and facilitate innovative thinking.

South West Water has been successfully re-accredited as a silver Investors In People (IIP) organisation during the year. After interviewing a cross-section of over 70 employees, IIP benchmarked South West Water within the top 1% of employers.

Staff and partners who deliver above and beyond what is required in their day-to-day jobs are eligible to be nominated for the company's Pure Award scheme in three categories – Pure Water, Pure Service and Pure Environment. Around 50 staff and partners were recognised for their contributions in this way last year.

The company conducts employee surveys, and this resulted in the establishment of several employee led working groups set up to focus on a number of key themes and deliver improvements. The key projects implemented from this were:

Crystal Clear communications – focusing on ensuring our communications with our employees are clear.

- creating a Pure Innovations scheme giving employees an easy route to promote their ideas
- improving the working environment (over £250,000 invested in improving and upgrading welfare facilities at sites and depots)

During 2011/12 South West Water's apprenticeship scheme grew with 16 new recruits joining the company. As one of the largest employers in the region we recognise that we have a key role to play in the regional economy and we continue to invest in the development of talent for the future.

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, 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.

### **Key relationships**

#### **Regulators and others**

South West Water actively engages with a wide variety of environmental and regulatory stakeholders. We take steps to ensure that communication is handled in the most appropriate way and that the information we provide is high quality and consistent. The company contributes to national policy on developing issues through its membership of Water UK, the industry trade body, and we work 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.

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

### **WaterFuture Customer Panel**

As part of the PR14 Price Review process under guidance from Ofwat we have created an independent 'WaterFuture' Customer Panel. Comprised of a select group of representatives from various regulatory, stakeholder and public bodies, their role in the coming year will be to ensure our business plan adequately reflects an understanding of our customers' priorities and that our planned activity is socially, economically and environmentally sustainable.

### **Procurement and suppliers**

Our procurement strategy is focused on partnering and strategic alliances with sixty key suppliers who account for the large majority of expenditure. We include all aspects of sustainability in our procurement processes and this is a central theme of our procurement strategy for our supply chains and support of the regional economy. With the start of the K5 regulatory period we introduced an innovative 'mixed economy' model to source our capital programme. This means using a significant number of smaller local contractors to provide specialised services as well as developing long-term relationships with more major supply chain partners. No supplier (revenue) accounts for more than 5% of revenue in the current or prior year and South West Water sources all its purchases from competitive markets.

It is the company's payment policy for the year ending 31 March 2013 to follow the Code of The Better Payment Practice Group on supplier payments. The company will agree payment terms with individual suppliers in advance and abide by such terms. Information about the Code may be obtained from The Better Payment Practice Group's website at [www.payontime.co.uk](http://www.payontime.co.uk). Trade creditors at 31 March 2012 represented 28 days of the amount invoiced by suppliers during the year (2010/11: 30).

### **Other information**

#### **Political donations**

No political donations were made in the current or prior year.

#### **Incidents and prosecutions**

During the year the company was convicted on 20 charges for environmental offences and fined a total of £86,000 (2010/11: five convictions and fines of £29,000).

#### **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.

#### **Parent company**

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

## **Principle Risks and Uncertainties**

The following have been identified from South West Water's risk management process as potentially having a material adverse effect on its business, financial condition, results of operations and reputation. They are managed as described but are not wholly within our control and may still result in a material adverse impact on the company. Factors beside those listed could also have a material adverse effect on our business activities.

## REPORT OF THE DIRECTORS (continued)

**KEY:** ↔ Unchanged during the year ↑ Increased during the year ↓ Decreased during the year

	<u>Risk</u>	<u>Mitigation</u>
<b>LEGISLATION &amp; REGULATION</b>		
1	Private sewers  ↔	<p>The company was well placed to manage the transfer of private sewers from 1 October 2011. Operational plans to manage customer contacts and deliver service to our customers, through two new contractors, were implemented smoothly and activity has been at the lower end of the expected ranges</p> <p>The company has appropriate risk management activities to monitor progress and a strategy in place for the further adoption of private pumping stations up to 2016</p> <p>Private sewer adoption operating and capital costs incurred efficiently will be funded by future adjustments to price limits</p>
2	Regulatory compliance  ↓	<p>As a regulated business subject to numerous and changing obligations with which we must comply, South West Water pays particular attention to the management of risks in these areas</p> <p>Performance against key regulatory outputs are reported to the Board on a monthly basis and where performance falls short, corrective programmes are developed and implemented to target recovery in a specific area</p> <p>There are a number of internal monitoring and assurance programmes which are undertaken through the year and annual data is supported by external verification through the company auditors to provide assurance on the company's compliance with its obligations</p>
3	Uncertainty arising from market and other regulatory reforms  ↔	<p>The company has considered the implications of the Government's Water White Paper and the regulatory price setting proposals within Ofwat's Future Price Limits consultation</p> <p>The Government's 'Water for Life' White Paper signals an evolutionary approach to market and regulatory reform over a period to 2025 and beyond. The development of greater competition in the water industry could reduce South West Water's revenues. As part of its risk management and business strategic planning processes the company evaluates developments and proposals for competition which could provide opportunities for business expansion</p> <p>South West Water is prepared for the development of retail competition, with the launch of 'Source for Business', offering enhanced services to our commercial customers. The company has evaluated proposals for regulatory reform and contributed fully to the Ofwat consultations on regulatory price setting and other forms of dialogue with regulators and stakeholders in order to effectively convey its views</p>

## REPORT OF THE DIRECTORS (continued)

	<u>Risk</u>	<u>Mitigation</u>
4	Environmental regulations and quality standards could increase the company's costs ↓	These issues are addressed in the five year regulatory price review mechanism. However, certain legislative obligations which arise within price control (i.e. private sewer adoption) are funded through future adjustments to price limits
5	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
<b>ECONOMIC CONDITIONS</b>		
6	Non-recovery of customer debt and affordability  ↔	<p>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. The use of third party collection agencies and implementation of Source Contact Management in the latter part of the year has stabilised collections performance.</p> <p>South West Water has also continued to fund and promote ways to help customers struggling to pay bills (WaterCare+, Restart, Fresh Start Fund) which seek to reduce bad debt exposure.</p> <p>The Government's commitment to tackle the 'unfairness' issue for South West Water customers, in which 3% of the population are effectively paying for 30% of the UK's bathing waters, has moved forward with legislation passed for a £50 reduction in bills for householders from 2013/14.</p>
7	Financial loss arising from the insolvency of a major supplier or contractor ↔	<p>The company does not have material exposure to payment before receipt of goods and services.</p> <p>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.</p>
8	Customer demand & other income  ↔	<p>South West Water has 73.4% of its domestic customer base metered. As a result the revenue from main charges can be more volatile from changes in customer usage which can be affected by a number of factors including:</p> <ul style="list-style-type: none"> <li>• abnormal weather impacts</li> <li>• increased water efficiency</li> <li>• recession impacting commercial customers</li> </ul> <p>The financial impact of changes in customer demand is mitigated through the regulatory Revenue Correction Mechanism, whereby shortfalls in revenue in one five year regulatory pricing period are adjusted in the following period.</p> <p>A number of the company's other income streams are vulnerable to downturns in economic activity, particularly in the property market affecting new connections, searches and mains diversion activity. In addition the non-appointed area where growth is targeted is challenging.</p>

## REPORT OF THE DIRECTORS (continued)

	<u>Risk</u>	<u>Mitigation</u>
<b>FINANCE &amp; FUNDING</b>		
9	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. South West Water is well placed for the funding requirements for the remainder of the K5 period.
10	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.
11	Poor investment performance may affect the defined benefit scheme assets and increase the pension scheme deficit ↔	Employee and employer contributions are kept under review and have been increased. Further contributions of £26.3m were made in the year. Pension trustees keep investment policy under review and use professional investment advisers.
<b>OPERATING PERFORMANCE</b>		
12	Water resource adequacy ↔	<p>The company has a number of schemes in place to maintain water resources (such as pumped storage for certain reservoirs) and promotes conservation measures and customer water efficiency measures.</p> <p>In addition capital investment in recent years including Park and Stannon lakes and the ongoing investment in a borehole have increased the resilience of our supplies.</p> <p>South West Water is not planning to introduce restrictions at this time but continues to monitor the situation. South West Water remains in a good position, bolstered by pumped storage activities utilised during 2011/12.</p> <p>South West Water also considers the longer term resource situation and 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 due to the impacts of climate change this position is frequently reviewed.</p>
13	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)

	<b>Risk</b>	<b>Mitigation</b>
14	Operational failures ↔	<p>Due to the nature of our business we continue to face risks arising during the normal course of our business, including risk of failure of our assets, processes or systems which could otherwise impact on the health, safety and security of our people or customers, or on our financial position and our reputation</p> <p>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, to maintain stable serviceability and avoid regulatory penalties</p>
15	Health & Safety ↔	<p>South West Water is committed to achieving the appropriate level of health and safety compliance. This year has seen the delivery of the behavioural safety programme badged 'TAP' and included safety leadership training for 150 staff and the establishment of safety coach roles. In addition senior management visits have been completed during the year across a number of sites</p> <p>The number of RIDDOR accidents for 2011 fell from 24 to 20, but fell short of the target of 18</p> <p>While continuous training is being provided, there is a need to ensure that appropriate health and safety working practices are embedded</p>
16	Customer Service ↑	<p>Customer service remains paramount to South West Water and the company focuses on improving customer satisfaction and reducing customer complaints</p> <p>At the beginning of K5 the targeted outputs were amended to target improved customer service. As a result greater focus was placed on overall customer service with comparison made against companies within the industry</p> <p>2011/12 is the first year that a financial penalty could be incurred by South West Water under Ofwat's Service Incentive Mechanism (SIM) for below average customer service performance</p> <p>The company has seen improvements in customer service particularly through reduced written complaints and there is a strategy for 2012/13 in place to improve customer service further</p>
17	Failure to deliver operating cost savings implicit in the regulatory review ↔	<p>In line with its track record, the company remains confident of delivering the required operating cost savings</p>
<b>CAPITAL INVESTMENT</b>		
18	Failure to deliver the capital investment programme ↔	<p>The company has a track record of delivering its capital programme in accordance with regulatory requirements and progress is regularly monitored and reviewed</p>

## REPORT OF THE DIRECTORS (continued)

	<u>Risk</u>	<u>Mitigation</u>
	<b>BUSINESS SYSTEMS</b>	
19	Business Systems ↓	<p>Whilst there always remains a risk of interruption, failure or third party intervention that could have a material adverse impact on the operations of South West Water, the company has well developed IT systems and business continuity systems in place</p> <p>The impact of a system failure or disruption to South West Water has been reduced with the refurbishment of the data centre at Peninsula House and the establishment of a geographically separate alternative data centre, which is hosted by a third party communications provider</p>

### Forward-looking statements

The Principal Risks and Uncertainties section contains forward-looking statements regarding the financial position, results of operations, cashflows, dividends, financing plans, business strategies, operating efficiencies, capital and other expenditures, competitive positions, growth opportunities, plans and objectives of management, and other matters. These forward-looking statements, including, without limitation, those relating to the future business prospects, revenues, working capital, liquidity, capital needs, interest costs and income in relation to South West Water, wherever they occur in this Principal Risks and Uncertainties section, are necessarily based on assumptions reflecting the views of South West Water, as appropriate.

They involve a number of risks and uncertainties that could cause actual results to differ materially from those suggested by the forward looking statements. Such forward-looking statements should, therefore, be considered in the light of relevant factors, including those set out in this 'Principal Risks and Uncertainties' section.

## BOARD OF DIRECTORS AND COMPANY INFORMATION

Chairman	K G Harvey
Chief Executive	C Loughlin
Operations Director	S C Bird
Finance & Regulatory Director	S J Davy
Customer Relations and Business Development Director	M S Read
Non-Executive Directors	Lord Taylor of Goss Moor M J Hagen
Secretary	K D Woodier
Co-Secretary	R C Zmuda (appointed 13 March 2012) M L Heeley (appointed 13 March 2012)
Registered Address	Peninsula House Rydon Lane Exeter EX2 7HR
Auditors	Pricewaterhouse Coopers LLP Chartered Accountants & Statutory Auditors 31 Great George Street Bristol BS1 5QD

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 parts of Somerset and Dorset.

## **STATEMENT OF DIRECTORS' RESPONSIBILITIES**

The directors are responsible for preparing the Directors' Report and the financial statements in accordance with applicable law and regulations. Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. In preparing these financial statements, the directors have also elected to comply with IFRSs, issued by the International Accounting Standards Board (IASB). Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period.

In preparing these financial statements, the directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgements and accounting estimates that are reasonable and prudent,
- state whether applicable International Financial Reporting Standards (IFRSs), as adopted by the European Union, have been followed, subject to any material departures disclosed and explained in the financial statements. In preparing these financial statements, the directors have also elected to comply with IFRSs, issued by the International Accounting Standards Board (IASB)
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the 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.

## NOTICE OF MEETING

The twenty-third Annual General Meeting of South West Water Limited will be held at Peninsula House, Rydon Lane, Exeter on 17 July 2012 at 10 30am for the transaction of the following business

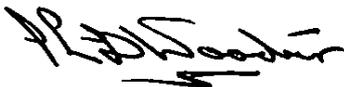
### **Resolution 1**

To receive the Report of the Directors and the audited financial statements for the year ended 31 March 2012

### **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

28 June 2012

For the purpose of the appointment of auditors (Resolution 2 in the 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

# **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 2012 which comprise the Income Statement, the Statement of Comprehensive Income, the Statement of Changes in Equity, the Balance Sheet, 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 Statement of Directors' Responsibilities set out on page 26, 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 and express an opinion on 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. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

## **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 2012 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  
28 June 2012

## Income statement for the year ended 31 March 2012

	Notes	2012 £m	2011 £m
<b>Revenue</b>		<b>474.7</b>	449.1
<b>Operating costs</b>	5		
Manpower costs (excluding restructuring costs)		(36.5)	(36.7)
Raw materials and consumables used		(14.4)	(14.2)
Other operating expenses		(116.1)	(107.5)
Depreciation		(100.5)	(97.0)
Restructuring costs	24	(2.5)	(4.0)
<b>Operating profit</b>		<b>204.7</b>	189.7
Finance costs	6	(122.4)	(83.5)
Finance income	6	59.1	22.6
<b>Net finance costs</b>		<b>(63.3)</b>	(60.9)
<b>Profit before tax</b>		<b>141.4</b>	128.8
Taxation	7	(11.9)	(3.7)
<b>Profit for the year</b>		<b>129.5</b>	125.1

The notes on pages 34 to 73 form part of these financial statements

## Statement of comprehensive income for the year ended 31 March 2012

	Notes	2012 £m	2011 £m
<b>Profit for the year</b>		<b>129.5</b>	125.1
Actuarial (losses)/gains on defined benefit schemes	22	(37.5)	0.3
Cash flow hedges net fair value (losses)/gains		(25.7)	0.2
Deferred tax credit/(charge) on items taken directly to equity	23	12.3	(2.2)
<b>Total other comprehensive expense</b>		<b>(50.9)</b>	(1.7)
<b>Total comprehensive income for the year</b>		<b>78.6</b>	123.4

## Statement of changes in equity for the year ended 31 March 2012

	Notes	Called up share capital £m	Retained earnings and other reserves £m	Total Equity £m
At 1 April 2010		150.9	274.9	425.8
Profit for the year		-	125.1	125.1
Other comprehensive expense for the year		-	(1.7)	(1.7)
Total comprehensive income for the year		-	123.4	123.4
<b>Transactions with equity shareholders</b>				
Dividends paid	8	-	(58.4)	(58.4)
Share based payments (net of tax)	26	-	1.5	1.5
Total transactions with equity shareholders		-	(56.9)	(56.9)
At 31 March 2011		150.9	341.4	492.3
Profit for the year		-	129.5	129.5
Other comprehensive expense for the year		-	(50.9)	(50.9)
Total comprehensive income for the year		-	78.6	78.6
<b>Transactions with equity shareholders</b>				
Dividends paid	8	-	(77.9)	(77.9)
Share based payments (net of tax)	26	-	1.1	1.1
Total transactions with equity shareholders		-	(76.8)	(76.8)
<b>At 31 March 2012</b>		<b>150.9</b>	<b>343.2</b>	<b>494.1</b>

The notes on pages 34 to 73 form part of these financial statements

## Balance sheet at 31 March 2012

	Notes	2012 £m	2011 £m
<b>Assets</b>			
<b>Non-current assets</b>			
Property, plant and equipment	11	2,541.1	2,467.8
Investment in subsidiary undertakings	14	3.3	3.3
Investment in joint venture	14	0.1	0.1
Trade and other receivables	13	1.0	0.6
		<u>2,545.5</u>	<u>2,471.8</u>
<b>Current assets</b>			
Inventories	15	3.7	3.3
Trade and other receivables	16	85.3	89.8
Derivative financial instruments	17	-	0.3
Cash and cash deposits	18	293.6	301.6
		<u>382.6</u>	<u>395.0</u>
<b>Liabilities</b>			
<b>Current liabilities</b>			
Borrowings	20	(68.7)	(60.3)
Derivative financial instruments	17	(13.5)	(4.4)
Trade and other payables	19	(81.2)	(96.6)
Current tax liabilities		(32.2)	(45.0)
Provisions for liabilities and charges	24	(3.7)	(2.7)
		<u>(199.3)</u>	<u>(209.0)</u>
<b>Net current assets</b>		<u>183.3</u>	<u>186.0</u>
<b>Non-current liabilities</b>			
Borrowings	20	(1,809.8)	(1,784.1)
Other non-current liabilities	21	(61.2)	(15.6)
Derivative financial instruments	17	(29.6)	(13.3)
Retirement benefit obligations	22	(77.9)	(68.2)
Deferred tax liabilities	23	(256.2)	(284.3)
		<u>(2,234.7)</u>	<u>(2,165.5)</u>
<b>Net assets</b>		<u>494.1</u>	<u>492.3</u>
<b>Shareholders' equity</b>			
Called up share capital	25	150.9	150.9
Retained earnings and other reserves	27	343.2	341.4
<b>Total shareholders' equity</b>		<u>494.1</u>	<u>492.3</u>

The notes on pages 34 to 73 form part of these financial statements

The financial statements on pages 30 to 73 were approved by the Board of Directors on 28 June 2012 and were signed on its behalf by



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

Registered office Peninsula House, Rydon Lane, Exeter, Devon, England EX2 7HR Registered Number 2366665

## Cash flow statement for the year ended 31 March 2012

	Notes	2012 £m	2011 £m
<b>Cash flows from operating activities</b>			
Cash generated from operations	28	269.1	266.0
Interest paid		(57.7)	(55.7)
Tax paid		(28.5)	(30.6)
<b>Net cash generated from operating activities</b>		<b>182.9</b>	<b>179.7</b>
<b>Cash flows from investing activities</b>			
Interest received		3.8	2.8
Receipt of grants and contributions		1.6	2.0
Purchase of property, plant and equipment		(138.7)	(118.1)
Proceeds from sale of property, plant and equipment		1.3	1.8
<b>Net cash used in investing activities</b>		<b>(132.0)</b>	<b>(111.5)</b>
<b>Cash flows from financing activities</b>			
Deposit of restricted funds		(26.9)	(46.6)
Net proceeds from new borrowing		-	15.0
Repayment of borrowings		(36.1)	(14.1)
Proceeds from inter-company borrowings		-	31.9
Finance lease sale and leaseback		65.0	0.5
Finance lease principal repayments		(4.0)	(12.1)
Dividends paid		(77.9)	(58.4)
<b>Net cash used in financing activities</b>		<b>(79.9)</b>	<b>(83.8)</b>
<b>Net decrease in cash and cash equivalents</b>		<b>(29.0)</b>	<b>(15.6)</b>
Cash and cash equivalents at beginning of the year	18	198.8	214.4
<b>Cash and cash equivalents at end of the year</b>	18	<b>169.8</b>	<b>198.8</b>

The notes on pages 34 to 73 form part of these financial statements

# NOTES TO THE FINANCIAL STATEMENTS

## 1. General information

South West Water Limited is a company registered in the United Kingdom under the Companies Act 2006. The address of the registered office is given on page 25. The nature of the Company's operations and its principal activities are also set out on page 25.

These financial statements were approved by the Board of Directors on 28 June 2012.

## 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.

### (a) Basis of preparation

These financial statements have been prepared on the historical cost accounting basis (except for fair value items, principally derivatives and adopted assets as described in accounting policy note (M) and (S) respectively) and in accordance with International Financial Reporting Standards (IFRS) and International Financial Reporting Interpretations 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 and interpretations in the year.

The going concern basis has been adopted for preparing the financial statements as stated by the Directors on page 9.

New or revised standards or interpretations which were mandatory for the first time in the year beginning 1 April 2011 did not have a material impact on the net assets or results of the Company.

At the date of approval of these financial statements IAS 19 (Revised) Employee Benefits was in issue, but not yet effective. Other standards and interpretations in issue, but not yet effective, are not expected to have a material effect on the Company's net assets or results.

The Directors anticipate that the adoption of IAS 19 'Employee Benefits' revised, expected on 1 April 2013, will potentially have a material impact, dependent on market conditions, on the financial statements of the Company. The revised standard is expected to increase net finance costs and operating costs. The extent of this impact is currently being assessed.

The preparation of financial statements in conformity with IFRS requires the use of estimates and assumptions which 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, actual events or actions and results may ultimately differ from those estimates.

## NOTES TO THE FINANCIAL STATEMENTS

### 2. Principal accounting policies (continued)

#### (b) Basis of consolidation

The Company is exempt under the provisions of section 400 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.

#### (c) Revenue recognition

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

Revenue is recognised once the services or goods have been provided to the customer.

Revenue from main water and waste water charges includes billed amounts for estimated usage and also an estimation of the amount of unbilled charges at the year-end based upon 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 apportioned basis using the effective interest method.

#### (d) 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 revenue is wholly generated from within the United Kingdom.

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

Cost includes original purchase price of the asset and costs attributable to bringing the asset to its working condition for its intended use. The cost of assets includes directly attributable labour and overhead costs which are incremental to the Company.

- 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 Company. The cost of day to day servicing of infrastructure components is recognised in the income statement as it arises.

## NOTES TO THE FINANCIAL STATEMENTS

### 2. Principal accounting policies (continued)

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 properties	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 Borrowing costs directly attributable to the construction of a qualifying asset (an asset necessarily taking a substantial period of time to be prepared for its intended use) are capitalised as part of the asset

Asset lives and residual values are reviewed annually

Gains or losses on disposals are determined by comparing the proceeds of sale with the carrying amount and are recognised within the income statement

#### **(f) Leased assets**

Assets held under finance leases are included as property, plant and equipment at the lower of their fair value at commencement or the present value of the minimum lease payments, and are depreciated over their estimated economic lives or the finance lease period, whichever is the shorter The corresponding liability is recorded as borrowings The interest element of the rental costs is charged against profits using the actuarial method over the period of the lease

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

#### **(g) Impairment of non-financial assets**

Assets with an indefinite useful life are not subject to amortisation and are tested annually for impairment, or whenever events or changes in circumstance indicate that the carrying amount may not be recoverable.

Assets subject to amortisation or depreciation are tested for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable

## NOTES TO THE FINANCIAL STATEMENTS

### 2. Principal accounting policies (continued)

An impairment loss is recognised for the amount by which an asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value, less costs to sell, and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Value in use represents the present value of projected future cash flows expected to be derived from a cash-generating unit, discounted using a pre-tax discount rate which reflects an assessment of the market cost of capital of the cash-generating unit.

Impairments are charged to the income statement in the year in which they arise.

#### (h) 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.

#### (i) 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.

#### (j) 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.

#### (k) Inventories

Inventories are stated at the lower of cost and net realisable value.

#### (l) Cash and cash deposits

Cash and cash deposits comprise cash in hand and short-term deposits held at banks. Bank overdrafts are shown within current borrowings.

## NOTES TO THE FINANCIAL STATEMENTS

### 2. Principal accounting policies (continued)

#### (m) 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 fair value, net of transaction costs incurred. Following initial recognition interest-bearing loans and borrowings are subsequently stated at amortised cost using the effective interest method.

Gains and losses are recognised in the income statement when the instruments are derecognised or impaired. Premia, 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 and hedging activities*

The Company uses derivative financial instruments, principally interest rate swaps, to hedge risks associated with interest rate and exchange rate fluctuations. Derivative instruments are initially recognised at fair value on the date the derivative contract is entered into and subsequently remeasured at fair value for the reported balance sheet.

The Company designates certain hedging derivatives as either

- a hedge of a highly probable forecast transaction or change in the cash flows of a recognised asset or liability (a cash flow hedge) or
- a hedge of the exposure to change in the fair value of a recognised asset or liability (a fair value hedge)

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

In order to qualify for hedge accounting the 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 ongoing basis. This effectiveness testing is reperformed at the end of each reporting period to ensure that the hedge remains highly effective.

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

Derivative financial instruments which 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.

## NOTES TO THE FINANCIAL STATEMENTS

### 2. Principal accounting policies (continued)

#### iii) *Financial assets at fair value through profit*

Financial assets at fair value through profit reflect the fair value movement of the hedged risk on a hedged item which has been designated in a fair value hedging relationship. The fair values of these financial assets are initially recognised on the date the hedging relationship is entered into and subsequently remeasured at each subsequent balance sheet date. The gain or loss on remeasurement for the period is recognised in the income statement.

#### iv) *Trade receivables*

Trade receivables do not carry any interest receivable and are recognised initially at fair value and subsequently at amortised cost using the effective interest method, less provision for impairment. A provision for impairment of trade receivables is established 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 and payment history.

#### v) *Trade payables*

Trade payables are not interest-bearing and are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

#### (n) **Taxation including deferred tax**

The tax charge for the year comprises current and deferred tax. Tax is recognised in the income statement, except to the extent that it relates to items recognised in the statement of comprehensive income or directly in equity. In this case tax is also recognised in the statement of comprehensive income or directly in equity.

Current tax is calculated on the basis of tax laws enacted or substantively enacted at the balance sheet date. Management periodically evaluates tax items subject to interpretation and establishes full provisions on individual tax items where, in the judgement of management, the position is uncertain.

Deferred tax is provided in full on temporary differences between the carrying amount of assets and liabilities in the financial statements and the tax base, except if it arises from initial recognition of an asset or liability in a transaction, other than a business combination, that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the assets can be realised. Deferred tax is determined using the tax rates enacted or substantively enacted at the balance sheet date, and expected to apply when the deferred tax liability is settled or the deferred tax asset is realised.

Deferred tax 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 for it to be utilised.

## NOTES TO THE FINANCIAL STATEMENTS

### 2. Principal accounting policies (continued)

#### (o) Provisions

Provisions are made where there is a present legal or constructive obligation as a result of a past event and it is probable that there will be an outflow of economic benefits to settle this obligation and a reliable estimate of this amount can be made. Where the effect of the time value of money is material, the current amount of a provision is the present value of the expenditures expected to be required to settle obligations. The unwinding of the discount to present value is included as notional interest within finance costs.

Provisions for restructuring costs are recognised when a detailed formal plan for the restructuring has been communicated to affected parties.

#### (p) Dividend distributions

Dividend distributions are recognised as a liability in the financial statements in the period in which the dividends are approved by the Company's shareholders. Interim dividends are recognised when paid, final dividends when approved by shareholders at the General Meeting.

#### (q) Employee benefits

##### i) *Retirement benefit obligations*

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

##### *Defined benefit pension schemes*

Defined benefit pension scheme assets are measured using bid price. Defined benefit pension scheme liabilities are measured by independent actuaries who advise on the selection of 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 liabilities. The increase in liabilities of the Company's defined benefit pension schemes expected to arise from employee service in the year is charged against operating profit.

The expected return on scheme assets and the increase during the year in the present value of scheme liabilities are included in other finance income or costs.

Changes in benefits granted by the employer are recognised immediately in income, in past service cost.

Actuarial gains and losses arising from experience items and changes in actuarial assumptions are charged or credited to equity in the statement of comprehensive income.

##### *Defined contribution scheme*

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

##### 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.

## NOTES TO THE FINANCIAL STATEMENTS

### 2. Principal accounting policies (continued)

At each balance sheet date, the Company revises its estimates of the number of options that are expected to vest. It recognises the impact of the revision to original estimates, if any, in the income statement, with a corresponding adjustment to equity.

#### (r) 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 non-current bank loans and other loans the fair value of financial liabilities for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate available to the Company for similar financial instruments.

#### (s) Transfers of assets from customers

Where an item of property, plant and equipment that must be used to connect customers to the network is received from a customer, or where cash is received from a customer for the acquisition or construction of such an item, that asset is recorded and measured on initial recognition at its fair value. The credit created by the recognition of the asset is recognised in the income statement. The period over which the credit is recognised depends upon the nature of the service provided, as determined by the agreement with the customer. Where the service provided is solely a connection to the network, the credit is recognised at the point of connection. If the agreement does not specify a period, revenue is recognised over a period no longer than the economic life of the transferred asset used to provide the ongoing service.

### 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.

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

##### i) Market risk

The Company has both interest bearing assets and interest bearing liabilities. The Company has a policy of maintaining, after the effect of interest rate swaps, at least 50% of interest bearing liabilities at fixed rates. At the year end 67% of net borrowings were at fixed rates and 24% 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 17.

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.

## NOTES TO THE FINANCIAL STATEMENTS

### 3. Financial risk management (continued)

At 31 March 2012, 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 decreased/ increase by £0.3m (2011: £0.2m)

If RPI on index linked borrowings had been on average 0.5% higher/lower with all other variables held constant, post-tax profit for the year would have decreased/increased by £1.3m (2011: £1.3m)

#### 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 sufficient available funds for operations and planned expansions equivalent to at least one year's forecast requirements at all times. Details of undrawn committed facilities and short-term uncommitted facilities are provided in note 20.

Contractual undiscounted cash flows were

#### 31 March 2012

	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
<b>Non-derivative financial liabilities</b>					
Borrowings excluding finance lease liabilities	31.5	21.1	93.3	1,271.40	1,417.3
Interest payments on borrowing	10.2	10.6	31.3	627.3	679.4
Finance lease liabilities	55.0	52.9	213.3	2,203.1	2,524.3
<b>Derivative financial liabilities</b>					
Derivative contracts – net payments	15.9	14.0	15.7	-	45.6

#### 31 March 2011

	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
<b>Non-derivative financial liabilities</b>					
Borrowings excluding finance lease liabilities	39.2	21.5	84.8	863.8	1,009.3
Interest payments on borrowing	16.2	17.7	54.7	557.3	645.9
Finance lease liabilities	38.7	50.3	199.3	2,234.1	2,522.4
<b>Derivative financial liabilities</b>					
Derivative contracts – net payments	12.4	8.2	3.0	-	23.6

#### iii) Credit risk

Credit risk arises from cash and cash deposits, derivative financial instruments and deposits with banks 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 13.

## NOTES TO THE FINANCIAL STATEMENTS

### 3. Financial risk management (continued)

Counterparty risk arises from the investment of surplus funds and from the use of derivative instruments. The Pennon Group 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.

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

The gearing ratios at 31 March 2012 and 2011 were as follows:

	2012	2011
	£m	£m
Net Borrowings (note 29)	1,584.9	1,542.8
Total equity	494.1	492.3
Total capital	<u>2,079.0</u>	<u>2,035.1</u>
Gearing Ratio	<u>76.2%</u>	<u>75.8%</u>

Consistent with the industry peer group, the Company is also monitored by the ratio of its Debt to Regulated Capital Value (RCV) in line with guidance from the water industry regulator Ofwat.

	2012	2011
	£m	£m
Regulatory Capital Value	2,826.8	2,703.5
Net Borrowings (note 29)	<u>1,584.9</u>	<u>1,542.8</u>
Net Debt / Regulatory Capital Value	<u>56.1%</u>	<u>57.1%</u>

#### (c) Determination of fair values

The Company uses the following hierarchy for determining the fair value of financial instruments by valuation technique:

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

## NOTES TO THE FINANCIAL STATEMENTS

### 3. Financial risk management (continued)

The disclosures are set out in note 17

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

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

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

### 4. Critical accounting judgements and estimates

The Company's principal accounting policies are set out in note 2 of 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

The Company recognises revenue at the time of delivery of services. Payments received in advance of services delivered are recorded as a liability.

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, revenue recognised is dependent upon the volume supplied including an estimate of the sales value of units supplied between the date of the last meter reading and the financial year-end. Estimated usage is based on historic data, judgement and assumptions, actual results could differ from these estimates which would result in operating revenue being adjusted in the period in which the revision of 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 doubtful debts based on experience including comparisons of the relative age of accounts and consideration of actual write-off history. The actual level of debt collected may differ from the estimated levels of recovery and could impact future operating results positively or negatively. As at 31 March 2012 the Company's current trade receivables were £76.3m, before the provision for impairment.

## NOTES TO THE FINANCIAL STATEMENTS

### 4. Critical accounting judgements and estimates (continued)

#### Retirement benefit obligations

The Company operates defined benefit pension schemes, through its parent company, for which actuarial valuations 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 Directors' best estimates using the advice of an independent qualified actuary and assumptions in the latest actuarial valuation. The assumptions are based on information supplied to the actuary, supplemented by discussions between the actuary and management. The principal assumptions used to measure schemes' liabilities, sensitivities to changes in those assumptions and future funding obligations are set out in note 22 of the financial statements

#### Taxation

The Company corporation tax provision of £32.2m and £6.8m relating to group relief, reflects the management's judgement of the amount of tax payable for fiscal years with open tax computations where liabilities remain to be agreed with HM Revenue & Customs. Management periodically evaluates items detailed in tax returns where the tax treatment is subject to interpretation. The Company establishes provisions on a full basis for individual tax items where, in the judgement of management, the tax position is uncertain

#### Defined benefit pension schemes

Directors' best estimates are based upon an assessment, with advice from the schemes' actuaries, of key financial and demographic assumptions

The rate used to discount schemes' liabilities reflects the market rate for long-term corporate bonds, adjusted for the projected duration of liabilities. Inflation is based upon the market rate observed at 31 March by reference to long-term index-linked bonds

Mortality assumptions are set upon actuarial advice in accordance with published statistics using a 'medium cohort' basis adjusted for scheme-specific experience, together with an allowance for future longevity improvements

A schedule showing the impact upon the schemes' liabilities of changes in the assumptions made is included in note 22 to these financial statements

#### Carrying value of property, plant and equipment

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 2012 was £2,541.1m. In the year ended 31 March 2012 additions to property, plant and equipment totalled £130.8m and the depreciation charge was £102.4m. Estimated useful economic lives of property, plant and equipment 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

Asset lives and residual values are reviewed annually and historically changes to remaining estimates of useful lives have not been material

## NOTES TO THE FINANCIAL STATEMENTS

### 4. Critical accounting judgements and estimates (continued)

#### Transfers of assets from customers

Where an item of property, plant and equipment is transferred from a customer and adopted by the Company it is recognised at fair value. Where the transaction price, if any, does not reflect the fair value of the transferred asset, management values the asset based on current replacement cost adjusted to the present condition of the asset. As many of these transferred assets are located underground, when assessing the fair value of the asset, management necessarily exercises judgement and estimation as to the condition and extent of the transferred asset.

### 5. Operating costs

	2012 £m	2011 £m
Manpower costs (note 9)	<u>36.5</u>	36.7
Raw materials and consumables	<u>14.4</u>	14.2
<b>Other operating expenses include</b>		
Profit on disposal of property, plant and equipment	(1.1)	(1.6)
Operating lease rentals payable		
- plant and machinery	1.3	1.1
- property	1.5	1.5
Research and development expenditure	0.2	0.2
Trade receivables impairment (note 16)	<u>8.5</u>	7.9
Depreciation of property, plant and equipment		
- owned assets	71.8	69.4
- under finance leases	<u>28.7</u>	27.6
	<u>100.5</u>	97.0

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

	2012 £000	2011 £000
Fees payable to the Company's auditors for the statutory audit of the Company	134	120
Other services pursuant to legislation	29	28
All other services	<u>192</u>	120
	<u>355</u>	268

Expenses reimbursed to the auditors in relation to the audit of the Company were £14,000 (2011 £14,000)

## NOTES TO THE FINANCIAL STATEMENTS

### 6. Net finance costs

	2012			2011		
	Finance cost £m	Finance income £m	Total £m	Finance cost £m	Finance income £m	Total £m
<b>Cost of servicing debt</b>						
Bank borrowings and overdrafts	(7.3)	-	(7.3)	(10.2)	-	(10.2)
Interest element of finance lease rentals	(37.8)	-	(37.8)	(29.4)	-	(29.4)
Other finance costs	(4.7)	-	(4.7)	(2.7)	-	(2.7)
Interest receivable	-	3.3	3.3	-	3.2	3.2
Intercompany interest (to)/from subsidiaries	(20.1)	-	(20.1)	(22.1)	0.1	(22.0)
	<b>(69.9)</b>	<b>3.3</b>	<b>(66.6)</b>	<b>(64.4)</b>	<b>3.3</b>	<b>(61.1)</b>
<b>Other finance income</b>						
Fair value losses on equity linked note derivative	(31.9)	-	(31.9)	-	-	-
Interest received on equity linked notes	-	33.6	33.6	-	-	-
	<b>(31.9)</b>	<b>33.6</b>	<b>1.7</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Notional interest</b>						
Retirement benefit obligations	(20.6)	22.2	1.6	(19.1)	19.3	0.2
	<b>(122.4)</b>	<b>59.1</b>	<b>(63.3)</b>	<b>(83.5)</b>	<b>22.6</b>	<b>(60.9)</b>

### 7. Taxation

	2012 £m	2011 £m
<b>Analysis of charge in year</b>		
UK Corporation Tax	27.7	23.7
Deferred tax - other	8.4	4.0
Deferred tax – arising on change of rate of corporation tax	(24.2)	(24.0)
	<b>(15.8)</b>	<b>(20.0)</b>
	<b>11.9</b>	<b>3.7</b>

UK corporation tax is calculated at 26% (2011: 28%) of the estimated assessable profit for the year

## NOTES TO THE FINANCIAL STATEMENTS

### 7. Taxation (continued)

The deferred tax credit for the year is due to a non-recurring credit of £24.2m (2011: £24.0m) arising from a 2% reduction in the rate of corporation tax. The tax for the year differs from the theoretical amount that would arise using the standard rate of corporation tax in the UK (26%). The differences are explained below:

	2012 £m	2011 £m
Profit before tax	<b>141.4</b>	128.8
Profit before tax multiplied by the standard rate of corporation tax in the UK of 26% (2011: 28%)	<b>36.8</b>	36.1
Effects of		
Expenses not deductible for tax purposes	1.1	0.7
Adjustments to tax charge in respect of prior year	(2.0)	(8.5)
Change in rate of corporation tax	(24.2)	(24.0)
Other	0.2	(0.6)
Tax charge for year	<b>11.9</b>	3.7

Credit adjustments to the tax charge in respect of prior years include amounts released from the prior year current tax liability where a reassessment of a number of tax items indicates that a tax deduction is now certain.

The average applicable tax rate for the year was 8% (2011: 3%).

In addition to the amount credited to the income statement, a deferred tax credit relating to actuarial losses on defined benefit schemes of £10.0m (2011: charge on actuarial gains £0.1m) has been charged directly to equity. A deferred tax credit relating to hedging reserve movements of £5.0m (2011: £nil) has been charged to equity. Deferred tax recognised directly to equity relating to share-based payments were £nil (2011: tax credit £0.5m).

### 8. Dividends

	2012 £m	2011 £m
Amounts recognised as distributions to equity holders in the year		
Base dividend of 38.7p per ordinary share in respect of 2010/11 paid 25 November 2010	-	58.4
Base dividend of 41.7p per ordinary share in respect of 2011/12 paid 29 September 2011	<b>62.9</b>	-
Dividend of 9.9p per ordinary share in respect of outperformance for 2010/11 paid 29 September 2011	<b>15.0</b>	-
	<b>77.9</b>	58.4

## NOTES TO THE FINANCIAL STATEMENTS

### 9. Employment costs

The average number of persons (including Directors) employed by the Company was 1,182 (2011 1,196)

	<b>2012</b>	2011
	<b>£m</b>	£m
Employment costs comprise		
Wages and salaries	<b>34.2</b>	35 0
Social security costs	<b>2.8</b>	2 7
Pension costs	<b>8.9</b>	11 0
Share-based payments	<b>1.1</b>	1 2
Total employment costs	<b>47.0</b>	49 9
Charged as follows		
Manpower costs	<b>36.5</b>	36 7
Capital schemes	<b>8.2</b>	9 5
Restructuring provision	<b>2.3</b>	3 7
Total employment costs	<b>47.0</b>	49 9

Details of Directors' emoluments are set out in note 10. 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.

### 10. Directors' emoluments

	<b>2012</b>	2011
	<b>£000</b>	£000
Total emoluments of the Directors of the Company		
Salary	<b>702</b>	658
Fees (non-executive Directors)	<b>60</b>	48
Performance-related bonus paid or payable	<b>266</b>	252
Share-based payments	<b>582</b>	575
Other emoluments	<b>178</b>	141
Total emoluments	<b>1,788</b>	1,674

The cost of share-based payments represents the amount charged to the income statement, as described in note 26.

The aggregate gains on vesting of Directors' share-based awards amounted to a total of £501,000.

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

## NOTES TO THE FINANCIAL STATEMENTS

### 10. Directors' emoluments (continued)

The performance related payment represents the cash element paid or payable. 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 criteria.

Other emoluments include car benefit and health care, and, in respect of two Directors, cash payment in lieu of any pension provision by the Company.

The emoluments of the highest paid Director were £517,000 (2011 £506,000).

At 31 March 2012 retirement benefits were accruing to two Directors (2011 three 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

### 11. Property, plant and equipment

	Freehold land and buildings	Infrastructure assets	Operational properties	Fixed and mobile plant, vehicles and computers	Construction in progress	Total
	£m	£m	£m	£m	£m	£m
<b>Cost:</b>						
At 1 April 2010	20.4	1,407.4	614.5	1,097.0	81.8	3,221.1
Additions	0.1	17.8	0.3	28.9	78.0	125.1
Assets adopted at fair value	-	12.4	0.6	1.7	-	14.7
Grants & contributions	-	(1.2)	-	-	-	(1.2)
Disposals	(0.1)	(1.8)	(4.4)	(52.2)	-	(58.5)
Transfers/reclassifications	0.9	21.7	11.3	30.1	(64.0)	-
<b>At 31 March 2011</b>	<b>21.3</b>	<b>1,456.3</b>	<b>622.3</b>	<b>1,105.5</b>	<b>95.8</b>	<b>3,301.2</b>
Additions	0.2	14.9	1.7	19.0	95.0	130.8
Assets adopted at fair value	-	46.7	-	-	-	46.7
Grants & contributions	-	(1.6)	-	-	-	(1.6)
Disposals	-	(0.9)	(0.1)	(1.7)	-	(2.7)
Transfers/reclassifications	0.8	14.0	5.2	61.6	(81.6)	-
<b>At 31 March 2012</b>	<b>22.3</b>	<b>1,529.4</b>	<b>629.1</b>	<b>1,184.4</b>	<b>109.2</b>	<b>3,474.4</b>
<b>Accumulated depreciation:</b>						
At 1 April 2010	4.5	81.7	167.3	539.9	-	793.4
Charge for year	0.3	21.5	11.1	65.4	-	98.3
Disposals	(0.1)	(1.8)	(4.4)	(52.0)	-	(58.3)
<b>At 31 March 2011</b>	<b>4.7</b>	<b>101.4</b>	<b>174.0</b>	<b>553.3</b>	<b>-</b>	<b>833.4</b>
Charge for year	0.6	22.2	11.2	68.4	-	102.4
Disposals	-	(0.9)	(0.1)	(1.5)	-	(2.5)
<b>At 31 March 2012</b>	<b>5.3</b>	<b>122.7</b>	<b>185.1</b>	<b>620.2</b>	<b>-</b>	<b>933.3</b>
<b>Net book value:</b>						
At 31 March 2011	16.6	1,354.9	448.3	552.2	95.8	2,467.8
<b>At 31 March 2012</b>	<b>17.0</b>	<b>1,406.7</b>	<b>444.0</b>	<b>564.2</b>	<b>109.2</b>	<b>2,541.1</b>

Out of the total depreciation charge for the Company of £102.4m (2011 £98.3m), the sum of £1.4m (2011 £1.3m) has been charged to capital projects, £0.5m (2011 £nil) has been offset by deferred income and £100.5m (2011 £97.0m) against profits

Asset lives and residual values are reviewed annually

Assets adopted at fair value include the impact of the transfer of ownership of private sewers to the Company on 1 October 2011

## NOTES TO THE FINANCIAL STATEMENTS

### 11. Property, plant and equipment (continued)

Assets held under finance leases included above were

	Land & buildings £m	Infrastructure assets £m	Operational Properties £m	Fixed and mobile plant, vehicles and computers £m	Construction in progress £m	Total £m
<b>Cost</b>						
At 31 March 2011	-	357.0	465.0	301.2	0.5	1,123.7
<b>At 31 March 2012</b>	-	<b>357.0</b>	<b>465.2</b>	<b>365.5</b>	<b>0.3</b>	<b>1,188.0</b>
<b>Accumulated depreciation</b>						
At 31 March 2011	-	26.0	89.2	154.5	-	269.7
<b>At 31 March 2012</b>	-	<b>31.3</b>	<b>97.0</b>	<b>167.6</b>	-	<b>295.9</b>
<b>Net book amount</b>						
At 31 March 2011	-	331.0	375.8	146.7	0.5	854.0
<b>At 31 March 2012</b>	-	<b>325.7</b>	<b>368.2</b>	<b>197.9</b>	<b>0.3</b>	<b>892.1</b>

### 12. 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		
<b>31 March 2012</b>						
<b>Financial assets</b>						
Trade and other receivables	13 & 16	-	9.3	13.3		22.6
Cash and cash deposits	18	-	293.6	-		293.6
		-	302.9	13.3		316.2
<b>Financial liabilities</b>						
Borrowings	20	-	(1,878.5)	-		(1,878.5)
Derivative financial instruments	17	(43.1)	-	-		(43.1)
Trade and other payables	19	-	(29.0)	(45.4)		(74.4)
		(43.1)	(1,907.5)	(45.4)		(1,996.0)

## NOTES TO THE FINANCIAL STATEMENTS

### 12. Financial instruments by category (continued)

	Note	Fair value	Amortised cost		Total £m
		Derivatives £m	Loans and receivables £m	Trade receivables and trade payables £m	
<b>31 March 2011</b>					
<b>Financial assets</b>					
Derivative financial receivables	17	0.3	-	-	0.3
Trade and other receivables	13 & 16	-	19.2	30.5	49.7
Cash and cash deposits	18	-	301.6	-	301.6
		<u>0.3</u>	<u>320.8</u>	<u>30.5</u>	<u>351.6</u>
<b>Financial liabilities</b>					
Borrowings	20	-	(1,844.4)	-	(1,844.4)
Derivative financial instruments	17	(17.7)	-	-	(17.7)
Trade and other payables	19	-	(37.7)	(56.6)	(94.3)
		<u>(17.7)</u>	<u>(1,882.1)</u>	<u>(56.6)</u>	<u>(1,956.4)</u>

£43.1m (2011 £17.4m) of the derivative value above is used for hedging with £nil (2011 £nil) deemed as held for trading

### 13. Trade and other receivables non-current

	2012 £m	2011 £m
Amounts owed by subsidiary company	<u>1.0</u>	<u>0.6</u>

The effective interest rate on amounts owed by subsidiary is 2.3% (2011 2.0%)

### 14. Investments

	2012 £m	2011 £m
At 31 March		
Subsidiary undertakings	<u>3.3</u>	<u>3.3</u>
Joint venture	<u>0.1</u>	<u>0.1</u>

The Company has five wholly-owned subsidiaries, Peninsula Properties (Exeter) Limited, Peninsula Leasing Limited, South West Water Finance Plc, Source Contact Management Limited and Source Collections Limited. All companies are incorporated, registered and operate in England.

## NOTES TO THE FINANCIAL STATEMENTS

### 14. Investments (continued)

The Company holds 99,999 (100%) A ordinary shares in Echo South West Limited, a joint venture previously engaged in customer contact management, established between the Company and Echo Managed Services Limited, a subsidiary of South Staffordshire 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).

The Directors believe that the carrying value of the investments is supported by their underlying net assets.

### 15. Inventories

	2012 £m	2011 £m
Raw materials and consumables	3.7	3.3

### 16. Trade and other receivables - current

	2012 £m	2011 £m
Trade receivables	76.3	85.0
Less provision for impairment of receivables	(63.0)	(54.5)
Net trade receivables	13.3	30.5
Amounts owed by subsidiary companies	0.2	1.9
Amounts owed by fellow subsidiary companies	1.0	1.3
Amount owed by parent undertaking	-	0.6
Other receivables	7.1	14.8
Prepayments and accrued income	63.7	40.7
	85.3	89.8

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

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

## NOTES TO THE FINANCIAL STATEMENTS

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

The ageing of gross trade receivables was

	2012 £m	2011 £m
Past due 1 - 30 days	10.2	10.9
Past due 31 - 120 days	9.7	10.5
Past due more than 120 days	94.5	83.0

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

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.

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

	2012 £m	2011 £m
At 1 April	54.5	46.6
Provision for receivables impairment	8.5	7.9
Receivables written-off during the year as uncollectable	(6.6)	(7.2)
Cumulative amounts previously excluded from debt	6.6	7.2
At 31 March	63.0	54.5

### 17. Derivative financial instruments

	2012 £m	2011 £m
<i>Derivatives used for cash flow hedging</i>		
Current assets	-	0.3
Current liabilities	(13.5)	(4.4)
Non-current liabilities	(29.6)	(13.3)

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

## NOTES TO THE FINANCIAL STATEMENTS

### 17. Derivative financial instruments (continued)

The ineffective portion recognised in the income statement arising from cash flow hedges was £nil (2011 £nil)

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 2012, 67% of net borrowings was at fixed rate (2011 59%)

At 31 March 2012 interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £705.0m existed, with a weighted average maturity of 3.3 years (2011 £605.0m, with 3.9 years). The weighted average interest rate of the swaps was 3.2% (2011 3.2%)

#### *Valuation hierarchy*

The amounts of financial instruments carried at fair value by valuation method were

	2012 £m	2011 £m
Level 2 inputs		
<b>Assets</b>		
Derivatives used for cash flow hedging	-	0.3
Total Assets	<u>-</u>	<u>0.3</u>
<b>Liabilities</b>		
Derivatives used for cash flow hedging	<u>43.1</u>	<u>17.7</u>
Total liabilities	<u>43.1</u>	<u>17.7</u>

The amounts above are the fair value of financial instruments using level 2 – inputs that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices). The fair value of swaps is based on the market value of equivalent instruments at the balance sheet date.

### 18. Cash and cash deposits

	2012 £m	2011 £m
Cash at bank and in hand	-	0.2
Overnight deposits	20.0	26.0
Other short-term deposits	165.1	195.2
Other deposits	<u>108.5</u>	<u>80.2</u>
	<u>293.6</u>	<u>301.6</u>

Other deposits include £108.5m (2011 £80.2m) of restricted funds to settle long-term lease liabilities (note 20)

## NOTES TO THE FINANCIAL STATEMENTS

### 18. Cash and cash deposits (continued)

For the purposes of the cash flow statement, cash and cash equivalents comprise

	2012	2011
	£m	£m
Cash and cash deposits as above	293.6	301.6
Bank overdrafts (note 20)	(15.3)	(22.6)
	<u>278.3</u>	<u>279.0</u>
Less deposits with a maturity of three months or more	(108.5)	(80.2)
<b>Cash and cash equivalents</b>	<u>169.8</u>	<u>198.8</u>

### 19. Trade and other payables - current

	2012	2011
	£m	£m
Trade payables	45.4	56.6
Amounts owed to parent undertaking	5.4	-
Amounts owed to subsidiary companies	3.3	17.7
Amounts owed to fellow subsidiaries	2.8	0.1
Other tax and social security	1.2	1.1
Other payables	4.4	3.8
Accruals	17.8	16.9
Deferred income	0.9	0.4
	<u>81.2</u>	<u>96.6</u>

### 20. Borrowings

	2012	2011
	£m	£m
<b>Current</b>		
Bank overdrafts	15.3	22.6
Short-term Loans	-	0.4
European Investment Bank	21.1	21.1
	<u>36.4</u>	<u>44.1</u>
Obligations under finance leases	32.3	16.2
<b>Total current borrowings</b>	<u>68.7</u>	<u>60.3</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 20. Borrowings (continued)

	2012 £m	2011 £m
<b>Non-current</b>		
European Investment Bank	231.5	252.5
Loan from subsidiary company	372.6	360.8
	<u>604.1</u>	<u>613.3</u>
Obligations under finance leases	1,205.7	1,156.2
Other bank loans	-	14.6
	<u>1,809.8</u>	<u>1,784.1</u>
<b>Total borrowings</b>	<u>1,878.5</u>	<u>1,844.4</u>

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

The fair value of the non-current borrowings were

	2012		2011	
	Book value £m	Fair value £m	Book value £m	Fair Value £m
European Investment Bank	231.5	205.7	252.5	219.5
Loan from subsidiary company	372.6	299.3	360.8	311.8
	<u>604.1</u>	<u>505.0</u>	613.3	531.3
Obligations under finance leases	1,205.7	1,050.4	1,156.2	929.2
	<u>1,809.8</u>	<u>1,555.4</u>	1,769.5	1,460.5

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

The maturity of non-current borrowings was

	2012 £m	2011 £m
Between 1 and 2 years	47.8	41.5
Between 2 and 5 years	231.9	171.7
Over 5 years	1,530.1	1,570.9
	<u>1,809.8</u>	<u>1,784.1</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 20. Borrowings (continued)

Finance lease liabilities - minimum lease payments

	2012 £m	2011 £m
Between 1 and 2 years	55.4	38.8
Between 2 and 5 years	266.5	246.3
Over 5 years	2,203.1	2,230.3
	<u>2,525.0</u>	<u>2,515.4</u>
Less future finance charges	<u>(1,287.0)</u>	<u>(1,343.0)</u>
	<u>1,238.0</u>	<u>1,172.4</u>

Finance lease liabilities - present value of minimum lease payments

	2012 £m	2011 £m
Between 1 and 2 years	55.0	38.8
Between 2 and 5 years	239.9	223.1
Over 5 years	1,011.5	1,003.2
	<u>1,306.4</u>	<u>1,265.1</u>

Included above are accrued finance charges arising on obligations under finance leases totalling £135.5m (2011 £130.8m), of which £12.6m (2011 £6.4m) is repayable within one year

Included above is £0.7m (2011 £0.7m) due to Peninsula Leasing Limited, a subsidiary company, under finance lease agreements of which £0.4m (2011 £0.4m) is repayable within one year

Within obligations under finance leases, the Company has utilised finance lease facilities of £180.0m for certain water and sewerage business property, plant and equipment 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 the Company at five-yearly intervals, the next being March 2016.

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 £41.9m at 31 March 2012 (2011 £32.4m) 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 other 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 2012 of £66.6m (2011 £47.8m) 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.

## NOTES TO THE FINANCIAL STATEMENTS

### 20. Borrowings (continued)

The Company has undrawn committed borrowing facilities at the balance sheet date

	2012 £m	2011 £m
Floating rate		
Expiring within one year	35 0	50 0
Expiring after one year	105 0	70 0
	<u>140 0</u>	<u>120 0</u>

In addition, the company has short-term uncommitted bank facilities of £50 0m (2011 £60 0m)

### 21. Other non-current liabilities

	2012 £m	2011 £m
Other payables and deferred income	<u>61.2</u>	<u>15 6</u>

### 22. Retirement benefit obligations

The Company's employees are eligible to participate in funded defined benefit pension schemes and also in defined contribution section within the main scheme, 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.

#### Defined contribution schemes

Pension costs for defined contribution schemes were £0 3m (2011 £0 2m)

#### Defined benefit schemes

The principal actuarial assumptions at the balance sheet date were

	2012 %	2011 %
Expected return on scheme assets	6.3	7.3
Rate of increase in pensionable pay	3.5	3.9
Rate of increase for current and future pensions	3.3	3.4
Rate used to discount schemes' liabilities	4.7	5.5
Inflation	3.3	3.4

Assumptions regarding future mortality experience are set based on actuarial advice in accordance with published statistics and experience. The mortality assumption uses a scheme-specific calculation based on CMI 2009 actuarial tables with an allowance for future longevity improvement.

## NOTES TO THE FINANCIAL STATEMENTS

### 22. Retirement benefit obligations (continued)

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

	2012	2011
Male	24.9	24.9
Female	27.0	26.9

The average life expectancy in years of a future pensioner retiring at age 62, 20 years after the balance sheet date, is projected at

	2012	2011
Male	25.8	25.7
Female	28.2	28.2

The sensitivities regarding the principal assumptions used to measure the schemes' liabilities are

	Change in assumption	Impact on schemes' liabilities
Rate of increase in pensionable pay	+/- 0.5%	+/- 1.3%
Rate of increase in current and future pensions	+/- 0.5%	+/- 6.0%
Rate used to discount schemes' liabilities	+/- 0.5%	+/- 8.5%
Inflation	+/- 0.5%	+/- 7.6%
Life expectancy	+/- 1 year	+/- 3.4%

The amounts recognised in the income statement were

	2012	2011
	£m	£m
Current service cost	(7.4)	(8.6)
Past service cost	(0.7)	(2.4)
Total included within operating costs	<b>(8.1)</b>	<b>(11.0)</b>
Expected return on pension schemes' assets	22.2	19.3
Interest cost on retirement benefit obligations	(20.6)	(19.1)
Total included within net finance costs	<b>1.6</b>	<b>0.2</b>
Total charge	<b>(6.5)</b>	<b>(10.8)</b>

The actual return on schemes' assets was an increase of £24.5m (2011 increase of £31.7m)

## NOTES TO THE FINANCIAL STATEMENTS

### 22. Retirement benefit obligations (continued)

The amounts recognised in the statement of comprehensive income were

	2012 £m	2011 £m
Actuarial gain/(loss) recognised in the year	<b>(37.5)</b>	0.3

The amounts recognised in the balance sheet were

	2012 £m	2011 £m
Fair value of schemes' assets	<b>353.7</b>	307.0
Present value of defined benefit obligations	<b>(431.6)</b>	(375.2)
Net liability recognised in the balance sheet	<b>(77.9)</b>	(68.2)

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

	2012			2011		
	Expected Return %	Value £m	Fund %	Expected Return %	Value £m	Fund %
Equities	8.1	177.5	50	8.5	176.0	57
Property	7.8	26.8	8	8.2	12.7	4
Bonds	3.8	117.6	33	4.8	91.0	30
Other	4.0	31.8	9	4.4	27.3	9
		<b>353.7</b>	<b>100</b>		<b>307.0</b>	<b>100</b>

Other assets principally represent cash contribution 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 diversification (currently property)

## NOTES TO THE FINANCIAL STATEMENTS

### 22. Retirement benefit obligations (continued)

The liabilities of the defined benefit schemes are measured by using the projected unit credit method which is an accrued benefits valuation method in which the scheme liabilities make allowance for projected earnings

Movements in net liability were	2012 £m	2011 £m
At 1 April	(68.2)	(83.3)
Income statement	(6.5)	(10.8)
Statement of comprehensive income	(37.5)	0.3
Regular contributions	8.0	9.0
Other employer contributions	26.3	16.6
At 31 March	<u>(77.9)</u>	<u>(68.2)</u>

Movements in the fair value of schemes' assets were

	2012 £m	2011 £m
At 1 April	307.0	264.3
Expected return on schemes' assets	22.2	19.3
Actuarial gains	3.7	12.2
Members' contributions	0.1	0.3
Benefits paid	(13.6)	(14.7)
Company regular contributions	8.0	9.0
Other employer contributions	26.3	16.6
At 31 March	<u>353.7</u>	<u>307.0</u>

Movements in the present value of schemes' defined benefit obligations were

	2012 £m	2011 £m
At 1 April	(375.2)	(347.6)
Service cost	(8.1)	(11.0)
Interest cost	(20.6)	(19.1)
Members' contributions	(0.1)	(0.3)
Benefits paid	13.6	14.7
Actuarial losses	(41.2)	(11.9)
At 31 March	<u>(431.6)</u>	<u>(375.2)</u>

The future cash flows arising from the payment of the defined benefits are expected to be settled primarily in the period between 15 and 40 years from the balance sheet date

## NOTES TO THE FINANCIAL STATEMENTS

### 22. Retirement benefit obligations (continued)

The five-year history of experience adjustments is

	2012	2011	2010	2009	2008
	£m	£m	£m	£m	£m
Fair value of schemes' assets	353.7	307.0	264.3	209.9	255.4
Present value of defined benefit obligations	(431.6)	(375.2)	(347.6)	(261.3)	(277.1)
Net liability recognised	(77.9)	(68.2)	(83.3)	(51.4)	(21.7)
Experience gains/(losses) on schemes' assets					
Amount (£m)	2.3	12.4	41.7	(80.7)	(53.6)
Percentage of schemes' assets	0.7%	4.0%	15.8%	(38.4)%	(21.0)%
Experience (gains)/losses on defined benefit obligations					
Amount (£m)	(3.5)	(9.7)	2.8	18.3	(5.8)
Percentage of defined benefit obligations	(0.8)%	(2.6)%	0.8%	7.0%	(2.1)%

The last triennial actuarial valuation of the Group's principle defined benefit scheme was at 1 April 2011. The Company has made deficit recovery contributions of £26.3m during the year (2011 £16.6m). The funding levels are monitored on an annual basis, and the Company expects to pay total contributions of £7.9m during the year ended 31 March 2013.

### 23. Deferred tax liabilities

Deferred tax is provided in full on temporary differences under the liability method using a tax rate of 24% (2011 26%).

The movements on deferred tax were	2012	2011
	£m	£m
At 1 April	284.3	302.6
Impact of change of corporation tax rate charged to the income statement	(24.2)	(24.0)
Impact of change of corporation tax rate credited to equity	2.7	2.1
Other deferred tax charged to the income statement	8.4	4.0
Credited to equity	(15.0)	(0.4)
At 31 March	<u>256.2</u>	<u>284.3</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.

## NOTES TO THE FINANCIAL STATEMENTS

### 23. Deferred tax liabilities (continued)

The deferred tax balance has been reduced by a net credit of £21.5m to recognise the changes in the rate of corporation tax enacted on 19th July 2011 and 26th March 2012 to reduce the rate from 1 April 2012 from 26% to 24%. If the published Government proposals to reduce the rate of corporation tax by a further 1% for each financial year until 2014/15 had been enacted at the balance sheet date the impact would be a further reduction of approximately £21.0m in total.

All deferred tax assets and liabilities are within the same jurisdiction.

The movement in deferred tax assets and liabilities is shown below.

	Accelerated tax depreciation		Total
	Owned Assets	Leased Assets	
	£m	£m	£m
At 1 April 2010	316.3	17.0	333.3
Impact of change of rate	(22.9)	(1.3)	(24.2)
Charged to the income statement	4.6	0.7	5.3
At 31 March 2011	298.0	16.4	314.4
Impact of change of rate	(23.0)	(1.3)	(24.3)
Charged to the income statement	0.9	0.7	1.6
<b>At 31 March 2012</b>	<b>275.9</b>	<b>15.8</b>	<b>291.7</b>

	Provisions	Retirement benefit obligations	Other	Total
At 1 April 2010	(2.4)	(23.3)	(5.0)	(30.7)
(Credited)/Charged to the income statement	(1.8)	4.1	(3.6)	(1.3)
Charged/(credited) to equity	-	0.1	(0.5)	(0.4)
Impact of change in rate	0.3	1.3	0.7	2.3
At 31 March 2011	(3.9)	(17.8)	(8.4)	(30.1)
(Credited)/charged to the income statement	(0.8)	7.5	0.1	6.8
Credited to equity	-	(10.0)	(5.0)	(15.0)
Impact of change in rate	0.4	1.6	0.8	2.8
<b>At 31 March 2012</b>	<b>(4.3)</b>	<b>(18.7)</b>	<b>(12.5)</b>	<b>(35.5)</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 23. Deferred tax liabilities (continued)

<b>Net deferred tax liability:</b>	<b>£m</b>
At 31 March 2011	284.3
<b>At 31 March 2012</b>	<b><u>256.2</u></b>

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

	2012 £m	2011 £m
Actuarial (losses)/gains on defined benefit schemes	(10.0)	0.1
Actuarial losses on defined benefit schemes (change of rate)	2.4	-
Share-based payments	-	(0.5)
Hedging reserve (change in rate)	0.3	0.3
Hedging reserve	(5.0)	-
Other impacts of change in rate	-	1.8
	<u>(12.3)</u>	<u>1.7</u>

### 24. Provisions for liabilities and charges

	2012 £m	2011 £m
Restructuring		
At 1 April	2.7	3.1
Charged to the income statement	2.5	4.0
Utilised during year	(1.5)	(4.4)
<b>At 31 March</b>	<u>3.7</u>	<u>2.7</u>

The restructuring provision related principally to severance costs and will be utilised within one year

### 25. Called up share capital

	2012 £m	2011 £m
<b>Authorised</b>		
500,000,000 Ordinary shares of £1 each	<u>500.0</u>	<u>500.0</u>
<b>Allotted and fully paid</b>		
150,950,000 (2011 150,950,000) Ordinary shares of £1 each	<u>150.9</u>	<u>150.9</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 26. Employee share schemes

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

#### i) Sharesave Scheme

An all-employee savings related plan is operated 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	
			2012	2011
6 July 2004	200p	2007 - 2011	-	52
5 July 2005	270p	2008 - 2012	24	25
4 July 2006	358p	2009 - 2013	22	92
3 July 2007	522p	2010 - 2014	45	51
8 July 2008	517p	2011 - 2015	39	134
6 July 2009	386p	2012 - 2016	738	760
28 June 2010	431p	2013 - 2017	277	296
29 June 2011	536p	2014 - 2018	222	-
			<b>1,367</b>	<b>1,410</b>

The number and weighted average exercise price of Sharesave options are:

	2012		2011	
	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	1,410	402	1,487	388
Granted	226	536	299	431
Exercised	(227)	390	(323)	350
Expired	(42)	438	(53)	482
At 31 March	<b>1,367</b>	<b>425</b>	<b>1,410</b>	<b>402</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 26. Employee share schemes (continued)

The weighted average price at the date of exercise of Sharesave options during the year was 656p (2011 478p). The options outstanding at 31 March 2012 had a weighted average exercise price of 425p (2011 402p) and a weighted average remaining contractual life of 1.8 years (2011 2.2 years).

The aggregate fair value of options granted during the year was £0.3m (2011 £0.5m), determined using the Black-Scholes valuation model. The significant inputs into the valuation model were:

	<b>2012</b>	2011
Weighted average share price	<b>670p</b>	539p
Weighted average exercise price	<b>536p</b>	431p
Expected volatility	<b>27.4%</b>	29.0%
Expected life	<b>3.9 years</b>	4.1 years
Risk-free rate	<b>1.4%</b>	1.4%
Expected dividend yield	<b>4.3%</b>	4.5%

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

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

Executive Directors and senior management receive a conditional award of Ordinary shares in Pennon Group Plc, 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:

	<b>2012</b>		<b>2011</b>	
	<b>Number of ordinary shares (thousands)</b>	<b>Weighted average exercise price per Share (p)</b>	<b>Number of ordinary shares (thousands)</b>	<b>Weighted average exercise price per share (p)</b>
At 1 April	<b>412</b>	<b>549</b>	393	553
Granted	<b>113</b>	<b>698</b>	130	546
Vested	<b>(64)</b>	<b>637</b>	(85)	557
Lapsed	<b>(57)</b>	<b>637</b>	(26)	557
At 31 March	<b>404</b>	<b>565</b>	412	549

## NOTES TO THE FINANCIAL STATEMENTS

### 26. Employee share schemes (continued)

The awards outstanding at 31 March 2012 had a weighted average exercise price of 565p (2011 549p) and a remaining contractual life of 1.3 years (2011 1.3 years). The aggregate fair value of awards granted during the year was £0.5m (2011 £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

	2012	2011
Weighted average share price	698p	546p
Expected volatility	27.4%	29.0%
Risk-free rate	1.4%	1.4%

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

#### iii) Annual Incentive Bonus Plan – deferred shares

Awards under the plan to Executive 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

	2012		2011	
	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	174	550	146	551
Granted	50	725	61	573
Vested	(61)	620	(33)	579
Lapsed	(5)	620	-	-
At 31 March	<b>158</b>	<b>589</b>	174	550

The awards outstanding at 31 March 2012 had a weighted average price of 589p (2011 550p) and a weighted average remaining contractual life of 1.3 years (2011 1.5 years). The Company's share price at the date of the awards ranged from 473p to 725p.

The aggregate fair value of awards granted during the year was £0.3m (2011 £0.3m), 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

### 27. Retained earnings and other reserves

	Hedging reserve £m	Retained earnings £m	Total £m
At 1 April 2010	(17.6)	292.5	274.9
Profit for the year	-	125.1	125.1
Other comprehensive income/(expense) for the year	4.8	(6.5)	(1.7)
Dividends paid	-	(58.4)	(58.4)
Share-based payments (net of tax)	-	1.7	1.7
Share options vesting (net of tax)	-	(0.2)	(0.2)
At 31 March 2011	<b>(12.8)</b>	<b>354.2</b>	<b>341.4</b>
Profit for the year	-	129.5	129.5
Other comprehensive expense for the year	(21.5)	(29.4)	(50.9)
Dividends paid	-	(77.9)	(77.9)
Share-based payments	-	1.1	1.1
At 31 March 2012	<b>(34.3)</b>	<b>377.5</b>	<b>343.2</b>

### 28. Cash flow from operating activities

Reconciliation of profit for the year to cash generated from operations

#### Cash generated from operations

	2012 £m	2011 £m
<b>Continuing operations</b>		
Profit for the year	129.5	125.1
Adjustments for		
Employee share schemes	1.1	1.2
Deferred income released to profits	(0.2)	(0.2)
Profit on disposal of property, plant and equipment	(1.1)	(1.6)
Depreciation charge	100.5	97.0
Interest payable and similar charges	122.4	83.5
Interest receivable	(59.1)	(22.6)
Taxation	11.9	3.7
Changes in working capital		
(Increase)/Decrease in inventories	(0.4)	0.2
Decrease/(Increase) in trade and other receivables	2.7	(18.4)
(Decrease)/Increase in trade and other payables	(13.0)	13.1
Decrease in retirement benefit obligations	(26.2)	(14.6)
Increase/(decrease) in provisions for liabilities and charges	1.0	(0.4)
Cash generated from operations	<b>269.1</b>	<b>266.0</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 29. Net borrowings

	2012 £m	2011 £m
Cash and cash deposits	293.6	301.6
<i>Borrowings - current</i>		
Bank overdrafts	(15.3)	(22.6)
Other current borrowings	(21.1)	(21.5)
Finance lease obligations	(32.3)	(16.2)
<b>Total current borrowings</b>	<u>(68.7)</u>	<u>(60.3)</u>
<i>Borrowings - non-current</i>		
Other non-current borrowings	(604.1)	(627.9)
Finance lease obligations	(1,205.7)	(1,156.2)
<b>Total non-current borrowings</b>	<u>(1,809.8)</u>	<u>(1,784.1)</u>
<b>Total net borrowings</b>	<u>(1,584.9)</u>	<u>(1,542.8)</u>

### 30. Operating lease commitments - minimum lease payments

	2012 £m	2011 £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	5.0	5.1
After five years	19.6	21.7
	<u>26.0</u>	<u>28.2</u>

### 31. Contingent liabilities

	2012 £m	2011 £m
Contractors' claims on capital schemes	-	0.2
Guarantee of borrowings of subsidiary undertaking	363.9	352.3
	<u>363.9</u>	<u>352.5</u>

### 32. Capital commitments

	2012 £m	2011 £m
Contracted but not provided	<u>51.0</u>	<u>67.2</u>

## NOTES TO THE FINANCIAL STATEMENTS

### 33. Related party transactions

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

<b><u>Parent company</u></b>	<b>2012</b>	<b>2011</b>
	<b>£m</b>	<b>£m</b>
Purchase of goods and services		
-Group expenses	<b>3.8</b>	3.7
Sale of goods and services		
-Administrative services	<b>0.5</b>	0.5
Dividends paid	<b>77.9</b>	58.4
<b><u>Subsidiaries of the Company</u></b>	<b>2012</b>	<b>2011</b>
	<b>£m</b>	<b>£m</b>
Purchase of goods and services		
-Property consultancy	<b>0.2</b>	0.3
-Billing and collection services	<b>3.5</b>	-
Payment for provision of finance		
-Loan interest	<b>20.1</b>	22.1
-Finance lease charges - vehicles	<b>0.1</b>	0.1
Sale of goods and services (administrative services)	<b>0.2</b>	0.3
Loan interest received	-	0.1
<b><u>Fellow subsidiaries of the Pennon Group</u></b>	<b>2012</b>	<b>2011</b>
	<b>£m</b>	<b>£m</b>
Purchase of goods and services		
-Waste disposal	<b>0.8</b>	0.6
-Insurance premia	<b>0.3</b>	0.4
Sale of goods and services		
-Tankered waste and trade effluent charges	<b>1.0</b>	0.8

## NOTES TO THE FINANCIAL STATEMENTS

### 33. Related party transactions (continued)

<u>Year end balances</u>	2012	2011
	£m	£m
<b>Borrowings</b>		
-Loan from subsidiary	372.6	360.8
-Finance lease balances with subsidiary	0.7	0.7
<b>Receivables</b>		
-Parent company	-	0.6
-Subsidiaries	0.2	2.5
-Fellow subsidiaries	1.0	1.3
<b>Payables</b>		
-Parent company	5.4	-
-Subsidiaries	3.3	17.7
-Fellow subsidiaries	2.8	0.1

### 34. 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.