

# SOUTH WEST WATER LIMITED

## ANNUAL REPORT AND FINANCIAL STATEMENTS 2013

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# Annual Report and Financial Statements 2013

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## Chief Executive's Review

At the core of South West Water's strategy is our commitment to delivering the services our customers depend on in the most cost effective and sustainable way possible

In 2012/13 we continued to outperform our efficiency targets for the current 'K5' regulatory period (2010-15), achieving strong financial results alongside operational excellence in many areas of the business, including drinking water quality, leakage control, and the prevention of interruptions to our customers' supplies

Our success in delivering efficiencies through K5 to date has enabled us to commit to re-investing £60m in order to enhance protection for bathing waters, maintain nearly six million metres of sewers and help those customers in the most need through debt initiatives

South West Water's operating profit increased by £10.5m to £215.2m. Increased revenue and rigorous cost control was underpinned by further efficiency, which the company continues to target through improved systems of working and a focus on innovation. Major investments were made in the improvement of waste water treatment works in order to deliver compliance, sewer rehabilitation, and clean water network improvements targeting reliability, water quality and security of supply

As predicted, the company was able to avoid imposing water restrictions for a 16th consecutive year, despite the driest conditions in over half a century recorded in early 2012. Our prior investment in the supply system, in addition to careful resource management and the use of pumped storage schemes during winter 2011/12, meant our customers could enjoy unconstrained supplies throughout the 'environmental drought' declared by the Environment Agency in mid-April 2012.

In stark contrast to the dry weather of early 2012, the latter half of the year and the start of 2013 was characterised by extreme wet weather, with widespread flooding affecting homes, businesses and transport links across the region. The number of internal and external sewer flooding incidents increased as a direct result, and the period April 2012 to March 2013 has subsequently been categorised as a 'one in 100-year' wet weather event. South West Water continues to work with local authorities and emergency services to identify and implement best practice for minimising the impact of such occurrences.

Together with below average temperatures during winter 2012/13, the unusually wet weather placed significant pressure on South West Water's assets and operations. While this served to highlight aspects of the business in which steps have been taken to improve resilience to extreme weather (for example the success of the flood defences at Pynes Water Treatment Works in Exeter which became the focus for a BBC news report), it also underlined the need for further investment to reduce the potential impact of such extreme weather events in future years.

Despite the wet weather and associated run-off and flooding, 133 out of 146 bathing waters (91%) achieved the European mandatory standard (good status) and 88 beaches (60%) achieved the guideline standard (excellent status). South West Water's commitment to delivering sustainable environmental improvements to the region's bathing waters was reflected in targeted investment over the past year in storm tanks, filtration and cleaning processes.

It is clear that South West Water must continue to invest in the improvement of its waste water network and systems in order to protect bathing water quality in the long term and meet emerging regulations.

As such, our 25-year 'WaterFuture' proposals which were published in December 2012 to underpin our investment programme for the 2015-2020 period, include targeted work to separate waste water (from homes and businesses) and surface water (e.g. from roadside drains). This will alleviate the risk of Combined Sewer Overflows (CSOs) discharging into rivers or the sea during periods of heavy rainfall.

Similarly, South West Water is committed to improving the efficiency and effectiveness of its waste water treatment processes. Following targeted investment in 96 sites over the last 18 months we achieved our highest compliance rates to date<sup>1</sup>

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<sup>1</sup> based on Population Equivalent Sanitary Compliance (99.98%) and Numeric Compliance (97.1%)

## Chief Executive's Review (continued)

With regard to pollution control, the number of serious (Category 1 and 2) incidents recorded in 2012 was substantially less than the previous year, however with increased pressure on our assets and network from the extreme wet weather there was a rise in the number of minor incidents (Category 3). We continue to focus on lowering the risk of pollution and it is our long-term aim to prevent harmful pollution incidents altogether. We plan to achieve this through 'sewer separation' work and treatment process enhancements, in addition to measures that limit the potential effects of extreme weather and climate change on our waste water treatment works.

South West Water continued its upward trend of improved customer service. This is reflected in the company's customer service score<sup>2</sup> showing an 88% improvement over the past three years. The number of written complaints have also halved over the same period.

The number of customer contacts regarding waste water issues was higher than that of a typical year, however this was expected - firstly, as a knock-on effect of the private sewer transfer (which was carried out in late 2011), and secondly, due to issues relating to the extreme wet weather. Notably, customer contacts regarding drinking water discolouration were substantially reduced.

In 2012/13 South West Water introduced a new Customer Relationship Management system. The company widened its use of online communication platforms (including social media) and continued to offer advice and support on water efficiency and affordability issues through schemes such as ReStart and WaterCare+. We also became one of the few water and sewerage companies to offer a social tariff which will help around 10,000 low income households from 2013/14.

Meanwhile, work to expand our offerings to business customers also continued through our specialist 'Source for Business' service.

In April 2013 the £50 Government Payment came into effect, designed to address the 'historic unfairness' that has, since privatisation, seen the three percent of the country's population that live in the South West effectively paying for the upkeep of one third of the nation's bathing waters. South West Water successfully managed the implementation of the Government-funded payment to its eligible domestic customers and the response from customers and stakeholders alike has been overwhelmingly positive.

South West Water continues to support and promote the wellbeing and development of its employees. In 2012/13 we achieved a considerable improvement in our health and safety statistics while also investing in future talent in the region through our apprenticeship scheme.

Looking ahead to the 2014 Price Review, South West Water has taken a proactive approach to customer engagement as part of the business-planning process. Independently commissioned research to garner customers' priorities has been complemented with an on and offline communications campaign featuring a bespoke 'WaterFuture' website ([www.southwestwater.co.uk/waterfuture](http://www.southwestwater.co.uk/waterfuture)) and the development of an online engagement tool.

In December 2012 we published our 25-year vision, designed to provide a context to the steps we plan on taking in 2015-2020. Published online and widely distributed to customers and stakeholder groups, the material was created in two formats - 'What's in the Pipeline 2015-2040' (a customer-orientated overview) and 'WaterFuture Our Vision 2015-2040' (an extended version for audiences requiring more specific detail).

The 25-year vision reflects the results of the research to date on customer and stakeholder priorities and outlines the company's core long-term aims as the delivery of reliable and responsive services that meets customers' needs, ensuring the environment is protected through sustainable actions and initiatives, and making resilient business decisions and investments. It also explores key investment

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<sup>2</sup> as measured by Service Incentive Mechanism (SIM)

## Chief Executive's Review (continued)

drivers for the 2015-2020 period. These include changes in regulation and legislation such as the Water Framework Directive, the importance of ensuring assets and networks can cope with the challenges of extreme weather and climate change, the need for a holistic approach to the prevention of pollution and sewer flooding, and future supply and demand needs.

An independently chaired 'WaterFuture Customer Challenge Panel' has also been created. Comprised of customer, community, regulatory and business stakeholders, its role is to ensure the company's final business plan reflects a sound understanding of customer and stakeholder opinion and that our proposals for the 2015-2020 period are economically, socially and environmentally sustainable.

The past year has shown that, come rain or shine, South West Water has the capacity to continue achieving industry-leading results in many spheres of the business, delivering high quality services that our customers can rely on. It has also served as a reminder that the challenges of a changing world can only be met through continued investment in both the maintenance and enhancement of our assets and operations.

As we move forwards, South West Water remains focussed on delivering reliable services, listening to its customers and stakeholders to ensure we respond to their needs and priorities while ensuring that the decisions we make continue to secure a resilient and sustainable future for our business, our workforce and our region.

With that in mind, I would like to express my gratitude to everyone in the team here at South West Water for their ongoing efforts and dedication.

Chris Loughlin,

Chief Executive

## Report of Directors

As a result of increased turnover and an ongoing strength in operational cost control, South West Water's operating profit increased in 2012/13 by £10.5m to £215.2m

Turnover grew by 5.4% to £500.1m as a result of tariff increases and new connections, partly offset by an overall reduction in demand and the effect of customers switching to a metered tariff

Approved tariff increases, including the 2.5% K factor, amounted to £38.1m, with an additional £1.5m generated by c.5,100 new customer connections. As a result of both the extreme wet weather experienced in the South West in 2012 and a reduction in commercial demand as a result of the dampened economic climate, overall customer demand has fallen by 2.9% against last year

Over 75% of South West Water's domestic customers are now benefitting from a metered supply, with an additional 12,631 customers (2012: 16,400) choosing to switch to a metered supply and enjoy lower average annual bills of £445 as a result

Our operating costs, including depreciation, rose by £14.9m to £284.9m

Overall cost increases were ahead of the 3.1% average inflation for the financial year, at 3.9% (£9.3m), but were in part offset by £3.5m of efficiency savings delivered in the year. Cumulative cost increases over the K5 period to date remain lower than average RPI for the same period

Other key drivers of operating cost increases year-on-year were

- operating expenditure transfers, reflecting the move towards capital maintenance schemes (£3.9m)
- further costs derived from the 2011 adoption of private sewers, reflecting a full year of operational costs (£1.5m)
- additional costs from new capital schemes of depreciation and asset management costs (£2.8m)
- other cost changes, predominantly as a result of increased cost of sales and non-recurring items (£0.9m)

Bad debt charges, equivalent to 1.9% of turnover, are marginally higher than the previous year, but improved significantly during the second half of 2012/13. The charge for bad and doubtful debts increased by £1.0m during the year, to £9.5m. Debts totalling £9.1m (2011/12: £6.6m) were written off against the provision during 2012/13, of which £2.5m relates to personal and commercial bankruptcy, and £1.1m related to our ReStart programme, a South West Water customer affordability initiative

South West Water's programme of organisational restructuring was weighted towards the beginning of K5. Ongoing operational and organisational changes have continued during 2012/13 with costs of £0.5m incurred in the period (2011/12: £2.5m)

### Capital Investment

Capital additions for the year were £116.5m, reduced from £130.8m in 2011/12

South West Water allocates capital expenditure between water and waste water activities

The key areas of focus remain

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

Investments during the year included

- improvements at waste water works targeting compliance
- innovative investments to reduce flooding for those customers previously highlighted at risk
- a programme of sewer rehabilitation and clean water network improvements targeting reliability
- water quality and security of supply
- improvements to private sewers

## Report of Directors (continued)

South West Water is continuing with asset enhancements enabling changed operational ways of working through the PUROS<sup>3</sup> programme

Whilst the overall capital spend has reduced, legislative or regulatory specific outputs have not been affected

### Property, Plant and Equipment

The directors are aware that the value of certain land and buildings in the balance sheet may not be representative of their market value. However, a substantial proportion of land and buildings comprises specialised operational properties and structures for which there is no ready market and it is not therefore practicable to provide a full valuation

### Financing

Net interest payable remained broadly in line with the prior year at £63.2m (2011/12 £63.3m), reflecting the lower interest on RPI index-linked bonds (resulting from a change in rates from 5.2% to 2.8%). The termination of a lease resulted in an exceptional net gain of £12.5m

Net debt increased by £15.5m during the year, reaching a total of £1,600.4m. The increase reflects the dividends payable, offset in part by lower capital spend and increased profits for the year (including exceptional items)

South West Water has access to overall interest rates that are amongst the lowest in the water industry. Interest cover for 2012/13 is both within the required levels for financial covenants and in line with expectations

Both Pennon Group and South West Water have robust treasury policies in place. These include policies that there are always pre-drawn or committed facilities to cover at least one year's estimated cashflow, and that no more than 20% of borrowing matures in any one year. The treasury function seeks to ensure that sufficient funding is available to meet foreseeable needs, maintain reasonable headroom for contingencies and manage interest rate risk. It operates within policies approved by the Board and does not undertake any speculative trading activity

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

Undrawn short-term committed credit facilities in place at 31 March 2013 totalled £105m (2012 £140m). The company also has short-term uncommitted bank facilities of £25m (2012 £50m). Approximately 24% of South West Water's debt is index-linked

Derivatives, usually interest rate swaps, are used to manage 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 £43.1m to £51.1m at 31 March 2013. The movement is taken to reserves through the Statement of Comprehensive Income for effective interest rate swaps, and through the Income Statement for those which were ineffective

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

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<sup>3</sup> Phased Utilisation of Remote Operating Systems (PUROS)

## Report of Directors (continued)

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 2013 equalled £2,915.7m, representing an increase of £88.9m (3.1%) in the year. The RCV at 31 March 2012 was £2,826.8m.

As a result, South West Water's net debt to RCV has decreased to 55%, remaining in line with Ofwat's optimum range of 55% to 65%.

The Board regularly monitors the company's expected financial requirements for the next 12 months. These will be met from existing cash balances, loan facilities and 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 continued economic downturn.

### Taxation

The overall tax charge for 2012/13 was £30.7m, an increase of £18.8m from the 2011/12 charge of £11.9m.

The current corporation tax charge is included within the tax charge, increasing by £16.9m on 2011/12. This reflects the increase in profit reported, offset by the decrease in corporation tax rates to 24%.

Deferred tax for the year was a credit of £13.9m (2011/12 credit £15.8m). The deferred tax credit is net of a credit of £10.6m from the impact of the reduction in the rate of corporation tax for future years. This will continue to change in line with corporation tax rates.

### Dividends and Reserves

Dividends of £133m were paid to the parent undertaking (2011/12 £77.9m), representing a base dividend of £65.8m and £67.2m of outperformance dividend based on two years cumulative performance to 31 March 2013. 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
- comparison with the assumptions made by Ofwat in setting prices for the K5 period

Dividend payments are designed to ensure that key financial ratios are not prejudiced, whilst also taking into account balance sheet considerations. Payments are also designed to ensure that the ability of the Appointee to finance its Appointed Business is not impaired.

### K5 Outperformance

In previous K periods, South West Water has historically shared the benefits of financial outperformance with customers through re-investment of efficiency and accelerating capital expenditure.

The strong operational and financial outperformance in K5 to date allows financial benefits to now be shared with customers.

South West Water is therefore investing c £60m in improving services to customers through

- upgrading assets in key bathing waters by accelerating capital investment

## **Report of Directors (continued)**

- maintaining and enhancing sewers that were adopted as part of the private sewer transfer in October 2011
- tackling customer affordability through debt initiatives

## Pure Water

South West Water's aim is to ensure its customers receive a reliable and safe supply of fresh, clean drinking water that not only meets the highest water quality standards but also looks and tastes great

In 2012/13 our drinking water quality remained outstanding. We maintained industry-leading leakage control and avoided water restrictions for the 16th consecutive year despite a period of drought in early 2012. We expanded our catchment management schemes to improve raw water quality and natural water storage in the landscape ('Upstream Thinking'), pioneered advanced processes at our treatment works to tackle taste and odour issues, and took innovative steps to improve the management of both our water resources and our workforce.

### Drinking Water Quality

The delivery of safe, high quality water is fundamental to South West Water's business. Water quality is measured by Mean Zonal Compliance. In 2012, South West Water once again achieved a near perfect standard (99.97%). This success can be attributed to our ongoing investment in the maintenance and improvement of both our drinking water treatment processes and our mains network.

In addition to achieving excellent water quality, South West Water is also committed to minimising any taste, odour or discolouration issues. During 2012/13 we carried out enhancements in this respect at the water treatment works at Prewley (Mid Devon) and Totitford (South Devon) while continuing with our mains rehabilitation programme.

South West Water also pioneered advanced oxidation using an innovative combination of UV light and hydrogen peroxide at Drift Water Treatment Works (West Cornwall).

A first-of-its-kind in the UK, this process helps remove naturally-occurring or man-made contaminants from raw water. This helps to protect drinking water from agricultural pollution while also improving its taste and reducing the amount of chlorine required for disinfection.

### Focus On Resilience Crownhill, Plymouth

To meet the needs of a growing population, South West Water plans to replace the water treatment works at Crownhill in Plymouth with a more efficient and secure new works north of the city.

The first step on this important journey was taken in early 2013 with the delivery of a small-scale research facility, manufactured by PWN Technologies in the Netherlands.

This miniature works, capable of processing 150,000 litres of water a day, uses state-of-the-art technology that is less chemical and energy-intensive than current processes.

The pilot facility is being tested using a variety of raw water sources including river and reservoir sources. This will help inform the design of the new treatment works which South West Water plans to deliver by 2018.

### Water Resources

In mid-April 2012, the Environment Agency declared the whole of the region as being in a state of "environmental drought". This followed an 18 month period of well below average rainfall and the driest March in the UK since 1953. Consequently, river flows and groundwater levels at the beginning of April were exceptionally low.

Despite some of the driest conditions in decades during early 2012, South West Water was able to continue delivering unrestricted supplies to its customers for the 16th consecutive year.

As predicted, South West Water was able to avoid water restrictions. Reservoir levels remained healthy – the strong storage position a direct result of pumped storage during winter 2011/12, investment in the supply system in 2011 and careful resource management.

## Pure Water (continued)

By contrast, April 2012 to early 2013 saw extremely high levels of rainfall, resulting in widespread flooding incidents across the country

South West Water's total reservoir storage levels reached 99.9% in February 2013

The company is confident that 2013 will be the 17th consecutive year without water restrictions. Our strategy is designed to ensure that we make the most of our existing resources as efficiently as possible and our long-term aim is to invest in our regional grid in order that water can be more efficiently moved to where it is needed most.

Regardless of our resource position, we also continue to raise awareness with our customers about how to use water wisely.

### Leakage Control

South West Water has demonstrated industry-leading leakage control since 1999.

In 2012/13 we met our leakage target of 84Ml lost on average per day.

The company expanded its pressure management activity to reduce the risk of failures in the network, increased its use of remote technologies to improve the efficiency of its leak detection teams, and took steps to improve the analysis of flow data in order that potential problems can be identified more quickly.

South West Water works with its leak detection and repair partners to ensure that additional resources are mobilised ahead of any extreme weather events.

We also encourage our customers to report leaks and bursts using our on and offline systems, including via social media.

The company's long-term strategy is to identify those pipes most at risk of a leak or burst and replace them before a problem occurs. This process is already being complemented through our investment in innovative leak detection technologies.

### Focus On Sustainability Upstream Thinking

'Upstream Thinking' is South West Water's flagship environmental programme to improve raw water quality and natural water storage at source through catchment management initiatives.

In 2012 this groundbreaking work won three awards:

- Water Industry Achievement Award for partnership initiative of the year
- the inaugural Finance for the Future Award, for financial leaders driving business sustainability (large business category)
- Utility Industry Achievement Award (environmental category)

There are two aspects to Upstream Thinking:

- 1 Working with farmers and landowners to reduce the amount of pollution and run-off entering the region's waterways.

South West Water has appointed local environmental charities, Westcountry Rivers Trust, Devon Wildlife Trust and Cornwall Wildlife Trust to work with landowners and farmers. The project includes farm visits, one-to-one advice, and the provision of grant funding for improvements, such as construction of new secure slurry storage and overwintering barns for stock.

The long-term benefits include:

- reducing the resources (e.g. chemicals) needed to intensively treat water
- increasing biodiversity
- reducing energy use for water treatment
- potentially delaying the need to upgrade water treatment works
- less contaminated water reaching our bathing and shellfish waters

In the five years 2010-2015, South West Water is targeting work in the Roadford, Wimbleball, Tamar Lakes, Otter, Fowey and Drift catchments.

## Pure Water (continued)

In 2012/13 more than 160 farm plans were delivered in the target catchments

### 2 Restoring wetland areas on the region's moors

Using locally developed ditch-blocking techniques and other environmentally sensitive procedures, the partners involved in Upstream Thinking are working to re-wet the region's peatlands

The benefits this will bring include

- a more consistent flow of water downstream which reduces flood risk
- improved water quality with less sediment and discolouration
- reduced water treatment costs
- restored habitats for local wildlife (including insects, amphibians, otters, snipe and curlew)
- carbon capture and storage

In the period 2010-2015, South West Water is targeting the restoration of 2,000 hectares of mires on Exmoor. There is also a pilot project to restore c 100 hectares on Dartmoor.

To date, the area for restoration on Exmoor has all been surveyed with 100 hectares now restored. One third of the restoration work on Dartmoor has also been completed.

## Pure Service

Delivering high quality services that represent value for money and meet customers' needs is essential

In 2012/13 South West Water continued to improve its level of customer satisfaction. Against the backdrop of extreme weather events ranging from drought to flooding, the company took steps to enhance its capacity to communicate with customers, respond to their diverse range of needs and resolve any issues or problems first time.

We successfully managed the knock-on effects of the Private Sewer Transfer in late 2011, began the roll-out of new metering technology, implemented the £50 Government payment and widened our services for business customers.

A new social tariff was also rolled out.

### Customer Satisfaction

Customer service is measured by the Service Incentive Mechanism (SIM). This takes into account a number of customer service aspects including the number of written complaints received and the results of customer satisfaction surveys.

In 2012/13 South West Water continued its upward trend of customer service improvement under SIM with a 5% increase on the previous year. This contributes to an 88% improvement since the beginning of K5.

The improvements in customer service in 2012/13 are particularly noteworthy given the circumstances within which they were delivered. In addition to the Private Sewer Transfer, which created, as expected, an increase in contacts regarding waste water issues, South West Water also had to manage the upsurge of customer contacts related to floodings caused by the extreme weather.

Despite these challenges, the number of written complaints received continued to fall, reaching a five-year low of 4,246 – half that received three years ago.

Our long-term strategy is designed, first and foremost, to reduce the likelihood that customers will need to report a problem or issue. In addition to ongoing improvements across the business at an operational level, this is being supported by an emphasis on multichannel communications including the use of online information systems such as BeachLive (which provides real-time information on bathing water quality) and WaterLive (which provides updates, by postcode, on work underway in the local area).

If a customer does need to make contact, South West Water is also taking steps to improve the experience they receive. In June 2012, a new Customer Relationship Management (CRM) system was introduced, designed to provide a faster and more integrated response to any issues. The intention is to expand its use in 2013/14 while continuing to encourage and promote web-based communications through avenues such as social media.

Customer satisfaction is also monitored by means of an independent long-term tracking survey. In 2012/13 this reported the average customer satisfaction rate at 84% (2011/12 85%).

### Focus On Responsiveness, Joining The Conversation Online

In addition to its website, online 'MyAccount' system (which now has almost 100,000 users), BeachLive and WaterLive websites, South West Water expanded its use of social media during 2012/13.

Recognising that applications such as Facebook and Twitter have become increasingly popular and effective communications channels, we have grown our online presence to enable customer queries.

## Pure Service (continued)

and issues to be raised online. South West Water's Twitter feed, which was introduced in November 2011 as a one-way resource for news items, is now being used for live dialogue with customers. This has helped to reduce unnecessary telephone contacts and improved our scope for communicating during major public incidents, such as the flooding in December 2012.

### Interruptions

South West Water customers regard a reliable supply of safe and clean drinking water as their number one priority. As such, it is our goal to avoid interruptions wherever possible and to take steps to minimise the impact of any interruption that does occur.

Interruptions can happen for a variety of reasons. These range from maintenance and improvement work on the water mains (planned interruptions) through to leaks, bursts and factors beyond our control such as the impact of third party construction work (unplanned interruptions).

Over the last three years, the average length of interruptions per customer has been substantially reduced. The completion of our water mains rehabilitation programme has inevitably resulted in a reduction in the amount of planned interruptions. Meanwhile, investment in asset renewal and the use of measures to limit the duration of interruptions (e.g. bypassing the damaged main using temporary hoses or using tankered water downstream of the burst) is also having a positive effect.

In the longer-term, South West Water's planned investment in the resilience of its drinking water network and in the duplication of strategic water mains will further reduce the risk and potential impact of interruptions. It is also our intention to adopt new technologies for mitigating their impact when there is a direct and cost-effective benefit to our customers.

### Metering

During 2012/13 South West Water installed nearly 13,000 meters, taking the percentage of our domestic customers who are metered to more than three quarters.

The company's long-term goal is to ensure that everyone pays according to what they use. As part of our metering strategy we began a programme of SMART metering in 2012/13. These transmit real-time information about water usage, thereby improving the accuracy and efficiency of our billing system while also giving customers a better understanding of how much water they are using.

South West Water also took steps to improve the productivity of its meter-reading field staff by introducing remote meter-reading devices with inbuilt GPS (satellite-based navigation). These enable staff to find individual meters with greater ease and accuracy and then feed information back into the central system without having to return to the nearest depot.

### Focus On Resilience, Protection From Extreme Events

In late 2012 the impact of extreme weather events was felt across the UK, with the disruption caused to lives and businesses dominating the headlines in the run up to Christmas.

For several days the rail line between Tiverton Parkway and Exeter St David's was blocked due to flooding. Located less than a kilometre away in the same low-lying flood plain, Pynes Water Treatment Works – the only water treatment works serving Exeter – was unaffected due to flood prevention measures put in place the previous year.

The incident highlighted just how important it is for water companies to mitigate the potential impact of extreme weather events in order to ensure services are unaffected.

## Pure Service (continued)

### Water Efficiency

Recognising that water is a precious resource, South West Water actively promotes and supports water efficiency with its domestic and business customers

In 2012/13 the company continued to deliver water efficiency initiatives, including

- undertaking water use reviews for customers with affordability issues
- undertaking water use reviews with business customers
- providing free water-saving devices for household customers
- giving water efficiency material and educational talks to regional schools
- providing online guidance and advice

### Affordability

The unique geography of the South West region has historically resulted in above average bills for South West Water customers

This is due, in part, to the burden of the multi-million pound investment required for the clean-up and protection of one third of the country's bathing waters falling on a small fraction of its total population. In a region with high house prices and below average incomes, South West Water recognises that affordability is an issue for some customers

We continue to consult with regulators, customers and stakeholders and offer a number of initiatives to assist those who genuinely struggle to pay their bills

Alongside initiatives carried out in association with the Citizens Advice Bureau, these include

- WaterCare+ scheme – which has now helped 11,691 customers through a benefits entitlement and tariff check, water audit and water efficiency measures
- Restart scheme – which has now helped 9,413 customers to reduce their debt through the incentivisation of regular payment patterns
- WaterSure tariff – for those in receipt of means-tested benefit or tax credit
- Fresh Start Fund – operated by Plymouth Citizens Advice Bureau for one-off hardship cases

In addition, South West Water is one of the few companies to have implemented a social tariff. From 2013/14, our WaterCare tariff is expected to assist around 10,000 households in the region. Eligibility will depend on an assessment of a customer's income and, where appropriate, a bill reduction will be made in order to enable them to pay

### The £50 Government Payment

First announced in 2011 and implemented in April 2013, the £50 Government Payment – an annual bill reduction of £50 for all eligible household customers - is recognition of the historic 'unfairness' associated with the bill impact of South West Water's environmental clean-up over the past two decades

Its announcement was welcomed by customers, regional media and MPs, many of whom had actively campaigned, alongside South West Water, for Government action on the issue

As the payment is passed directly through to customers there is no impact on the company's finances

### Business Customers

South West Water has continued to expand its relationships with commercial and other non-domestic customers (e.g. local councils, hospitals and other public bodies) during 2012/13

Against the backdrop of difficult economic circumstances, the advice and assistance available from South West Water through 'Source for Business' is being well-received by the region's business community

The Source for Business services include

- dedicated contact routes to business customer specialists

## Pure Service (continued)

- bill validation
- a named account manager for larger organisations
- effluent and process management
- laboratory and analytical services
- water and process efficiency advice
- advice on capital solutions
- project management through design and build to operation and maintenance

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

### Case Study Papa Pumps

Source for Business is always looking to provide our customers with innovative ways to improve water efficiency and help reduce their costs

One such solution is the PAPA Pump, which features only two moving parts and is powered by water flow rather than an external energy source

Exclusive to Source for Business, the PAPA Pump was developed in the South West and has a multitude of applications. It is particularly relevant for farmers and other land users needing a cost-effective method of moving water, and once fully installed, savings on energy and water usage mean the investment is usually paid back in under 18 months

## Pure Environment

Recognising the vital importance of the environment to the economy and quality of life of the South West region, South West Water aims to minimise its environmental impact. Our goal is to protect the natural condition of the world around us through sustainable actions and initiatives.

### Waste Water Treatment

In 2012, South West Water's longstanding endeavours to raise the standard of the waste water it returns to the environment were reflected in its best ever compliance for the percentage of the population served by waste water treatment works that meet the required criteria ('Population Equivalent Sanitary Compliance')

Another measure that looks at a much wider range of compliance parameters is Numeric Compliance of Waste Water Treatment Works (which gives equal weighting to small and large treatment works). Similarly, South West Water performed well, achieving a record high of 97.1%. This can be attributed to a programme of targeted investment in waste water treatment processes at 96 operational sites over the past 18 months.

In each case our performance is within the reference levels used by Ofwat to determine 'stable serviceability'.

We recognise that more stringent bathing, shellfish and river water quality standards are set to come into effect, including the Revised Bathing Water Directive in 2015.

South West Water will continue investing in the maintenance and improvement of our waste water treatment works and processes in order that they meet or exceed the standards set by our regulators. This will include investment in areas such as phosphate and nitrate removal and in the resilience of our waste water treatment assets.

### Bathing Water Quality

Our region has more designated bathing waters than any other in England and Wales, and in the past two decades South West Water has made significant investment to improve bathing water quality. Extreme wet weather can adversely affect bathing water quality when heavy rain impacts on urban drainage and agricultural run-off. Heavy storms can also trigger the operation of combined sewer overflows (CSOs) in the sewerage system.

Despite the extreme weather and the associated run-off and flooding during 2012, 133 out of 146 (91%) of the region's bathing waters achieved the mandatory or 'good' standard.

88 bathing waters (60%) also achieved the guideline or 'excellent' standard which is now being reported using stricter criteria than that of previous years.

Our long-term ambition is to enhance protection for bathing water quality through an innovative and holistic approach to waste water management.

In addition to investment in our assets and network (e.g. 'sewer separation' work to separate surface water from the waste water from homes and businesses), this 'Downstream Thinking' programme will include working with partner organisations to tackle all of the other issues that can impact on bathing water quality. These include urban drainage, agricultural run-off, birds and other wildlife, private sewers and misconnections.

## Pure Environment (continued)

### Pollution Control

Pollution incidents are classified by the Environment Agency into four categories

Category 1 Major/serious/persistent

Category 2 Significant

Category 3 Minor/minimal

Category 4 No impact

In 2012, South West Water successfully avoided any Category 1 or 'major' incidents and saw a significant drop in the number of Category 2 incidents compared with the previous year (2011 15, 2012 4)

This can be attributed to the proactive work we have undertaken to improve our maintenance schedules, monitoring systems and response times, including the roll-out and expansion of BeachLive – which provides real time information on the operation of CSOs

Our performance on Category 3 or 'minor/ minimal' incidents was not as favourable 202 incidents were recorded in 2012 compared with 131 in 2011

South West Water considers all pollution incidents to be unacceptable and the Category 3 result for 2012 is regrettable

However, the results do need to be considered in the context of the extreme wet weather 2012 has been classified as a 'one in 100 year' extreme weather event This inevitably put pressure on our assets and networks Foul sewers and pumping stations in particular were affected, increasing the likelihood of a pollution incident occurring

We continue to invest in the maintenance and improvements necessary to reduce the risk of pollution and it is our aim to ensure that there are no harmful pollution incidents

In 2012/13 we continued with our programme of sewer rehabilitation and also created 1,200m<sup>3</sup> of additional sewer storage to reduce the likelihood of sewers and waste water assets becoming overburdened during periods of extreme wet weather

### Flooding

As a year of abnormally wet weather, 2012 saw a dramatic rise in the number of flooding incidents in the South West River flows and groundwater levels reached exceptionally high levels, increasing the threat of flooding for many homes and businesses

The number of internal sewer floodings (an incident in which sewage enters a property) totalled 266 Within this total, there were 118 repeat internal floodings compared with 31 in 2011/12

Inevitably, a high proportion of floodings were caused by the sewerage system becoming overwhelmed by the sheer volume of water

Steps were taken throughout the course of the year to fine-tune South West Water's approach to flooding events

Internal and external communications have been reappraised to improve customer service and an improved early warning weather monitoring system put in place

Previous investment in sewer level monitoring and other remote technologies proved invaluable The flooding events have also enabled South West Water to assess and improve its working relationships with the other regional agencies and organisations affected

## Pure Environment (continued)

### Energy and Carbon

As one of the largest energy users in the region, South West Water has both an environmental and economic incentive to minimise its energy use and carbon footprint wherever possible

In 2012/13, the unusually wet weather in the latter half of the year resulted in annual energy usage totalling 270GWh – around 10GWh above that of the previous year. While the wet conditions contributed to a drop of almost 10% in the amount of energy necessary for drinking water operations, the increased need for pumping on the waste water side of the business resulted in an energy usage increase of around 14%.

#### • Energy efficiency

South West Water's energy efficiency measures achieved an above-target saving of 5.81GWh in 2012/13. The company continues to target energy efficiency through its programme of pump refurbishments and replacements at both drinking water and waste water treatment sites. The optimisation of our assets and networks is also being complemented by the use of remote technologies to control processes and equipment from a central hub as part of our PUROS project. In addition, South West Water's 'Powerdown' energy efficiency campaign promotes and supports company-wide energy efficiency. Together with lighting refits at several of our largest sites, including Restormel Water Treatment Works in Cornwall, the total energy saving made by Powerdown in 2012/13 was 1.9GWh.

The company continues to target energy efficiency through its programme of pump refurbishments and replacements at both drinking water and waste water treatment sites.

#### • Renewable energy

South West Water's goal is to have 30GWh of its energy usage supplied from renewable sources by 2015. In 2012/13 we made excellent progress, generating more power from renewables than ever before. In total, 19.3GWh was harnessed from a combination of solar, wind, hydro and combined heat and power from waste (CHP).

The extreme wet weather, while serving to increase our energy demand, was highly advantageous for our hydro power sites. We continue to invest in hydro power and other renewable technology. Despite below average annual sunshine, South West Water's 24 existing solar PV installations performed well and we installed an additional seven schemes. Our wind turbine at Lowermoor Water Treatment Works also outperformed its target generation level for the year.

#### • Greenhouse gas emissions

South West Water's energy strategy is designed to limit greenhouse gas emissions through a combination of energy efficiency and renewable energy schemes.

In 2012/13 our greenhouse gas emissions remained below the 2009/10 baseline of 161.7tCO<sub>2</sub>e, however the demands placed on us due to the extreme weather meant we were unable to meet our target level for the year.

The company remains committed to reducing its carbon emissions by 80% by 2050 and we continue to be accredited to the Certified Emissions Measurement and Reduction Scheme (CEMARS).

## People and Community

South West Water's vision is to sustainably improve services and be a good neighbour while having a positive impact on the communities we serve and the people we employ

In 2012/13 we continued with our community outreach initiatives, expanded our apprenticeship programme to help nurture local talent for the future, and provided sponsorship and support for a range of educational and environmental projects and events. We developed a new 'People' strategy to benefit the wellbeing and development of our staff and achieved our best ever health and safety score

We also continued to promote recreational opportunities around the region's reservoirs and waterways through our partner organisation, the South West Lakes Trust

### Community Support

South West Water's support for communities around the region during 2012/13 included

#### • Community sponsorship

Our annual budget of £80,000 is targeted at community projects and organisations which are linked to water, benefit the environment, or promote youth participation. Examples in the past year included sponsorship of the Institute of Water's Autumn Weekend School, the Cornwall Wildlife Trust's Living Seas Ball and the Surf Life Saving Association's Nipper Championships

#### • Support during construction schemes

The H50 Delivery Alliance engineering team received positive feedback during the year from a range of community representatives following their efforts to minimise the impact of construction work. This included praise from the town council in Fowey, where the engineers who were working on the sewage pumping station at Town Quay repaired the private pipes which supply Fowey Aquarium with fresh seawater

#### • Community outreach

South West Water's 'customer caravan' attended more than 140 public events throughout 2012/13, giving out water efficiency advice, water-saving devices and 'fat traps', while also carrying out survey work on customer priorities ahead of the 2014 Price Review. We also continued with our public speaking programme, providing talks to 15 clubs and other local organisations

#### • Opening up our sites to the public

A number of Heritage Open Days were held during the year, providing historic tours of operational sites such as Pynes Water Treatment Works and Countess Wear Waste Water Treatment Works in Exeter and Coswarth Service Reservoir in Newquay

#### • Volunteering

South West Water staff took part in a variety of voluntary activities including beach cleans, tree-planting and habitat management

#### • Director level support for the local economy through Local Enterprise Partnerships (LEPs)

Two South West Water Directors are represented on the Local Enterprise Partnerships. Our Chief Executive is deputy chairman of the Cornwall and Isles of Scilly LEP, and our Operations Director sits on the Heart of the South West LEP. Other Directors act as members of the South West Lakes Trust Board and provide support to Exeter University

#### • Fundraising

South West Water continues to support our industry charity, WaterAid. Our employees undertake substantial fundraising and we also promote the charity to our customers

## People and Community (continued)

We fund the annual WaterAid customer campaign, leading to significant donations from across the region

The campaign has raised over £4m since its inception

### **Educational Support**

Developing the local skills base is vital to the regional economy and a key part of South West Water's sustainability strategy

#### **• Apprenticeships**

Eight new apprentices were recruited across the business during 2012/13 through South West Water's apprenticeship programme, developed in partnership with South Devon College. They join the 16 trainees recruited in 2011/12

#### **• Support for University Technical College bid**

Together with South Devon College, Exeter University, Centrax and Galliford Try Construction, South West Water supported the £10m bid submission to the Department of Education for a University Technical College to be established in the South West. It is proposed that students aged between 14 and 18 will specialise in studying Engineering, Water and Environment, helping to develop the local skills base and enabling them to access employment opportunities, including those at South West Water

#### **• Work experience placements and guest lectures**

South West Water provides work experience placements to school and university students and in 2012/13 three 'Year in Industry' students were placed with the company. Our employees also lectured on courses at Exeter, Plymouth and Bristol Universities, and at Bicton College, Devon

#### **• Support for primary and secondary schools**

At secondary school level, we provided support to The Smallpeice Trust, an independent educational charity that runs hands-on Science, Technology, Engineering and Maths (STEM) activities and engineering courses for pupils in Years 6-12. We also provided educational materials to local schools, including science experiments to demonstrate the water cycle to primary school children

### **Employees**

South West Water prides itself on being a responsible employer, attaching paramount value to the safety, training, needs and ambitions of its employees. The company is recognised as a 'silver' Investors in People (IIP) organisation, and IIP ranked South West Water within the top 1% of employers

During 2012/13 we developed a new People Strategy, focussed on attracting, recruiting, retaining, rewarding, recognising and developing our workforce. It is our aim to be the 'Employer of Choice' in the South West and we provide employees with the opportunity to develop their careers through a number of schemes

Over the past year we delivered

- a new development programme for senior managers (LEAD 2020)
- supplementary training through our Management Academy to advance business knowledge, enhance personal effectiveness and facilitate innovative thinking
- a new Manager First 100 day programme
- customer service training to improve our service and SIM performance
- NVQ programmes

## **People and Community (continued)**

To further encourage a committed and valued workforce, South West Water rewards those who deliver above and beyond that which is required in their day-to-day jobs through our in-house Pure Award scheme

We conduct employee surveys, establishing working groups to deliver any potential improvements identified and we also support innovation through the Pure Innovations scheme which gives employees a route to promote their ideas

### **Focus On Sustainability**

#### **Apprenticeship Programme**

South West Water's apprenticeship programme plays a key role in the company's sustainability strategy as we recognise the need to nurture talent for the future and ensure that vital skills are passed on to the next generation

20-year old Joe Farrant is currently studying mechanical engineering at South Devon College while gaining practical experience at South West Water's workshop in Exeter

Selected from over 400 applicants, Joe was one of 16 technicians recruited by South West Water in 2011 to its Drinking Water and Operations Support functions

#### **Health and Safety**

The number of health and safety incidents as recognised by RIDDOR (Reporting of Injuries, Diseases, and Dangerous Occurrences) dropped to an all time low in 2012/13

This success can be attributed to the steps we have taken to implement and promote a safe working environment

Our Health and Safety strategy (which is promoted by a health and safety steering group comprising a cross-section of directors, managers and employee representatives) focuses on providing strong leadership, behavioural safety, building competencies, and driving improvement through the measuring of performance

We also continue to promote in-house safety campaigns such as 'TAP' (Think, Act, Prevent), to help develop a positive health and safety culture

#### **Employee policies**

South West Water has a range of 'family friendly' policies, which go beyond statutory requirements. We remain 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, we welcome 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

All employees are entitled to participate in the Pennon Group Sharesave Scheme and the Pennon Group Share Incentive Plan, both of which are 'all-employee' plans where performance conditions do not apply

## People and Community (continued)

### 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.

#### • WaterFuture Customer Panel

As part of the 2014 Price Review process, under guidance from Ofwat, we created an independent 'WaterFuture' Customer Panel. Comprised of a select group of representatives from various regulatory, stakeholder and public bodies, the panel's role is to ensure our final business plan adequately reflects an understanding of our customers' priorities and that our planned activity is socially, economically and environmentally sustainable.

During 2012/13 the panel met in its entirety on eight occasions, with a further 14 sub-committee meetings attended by members.

#### • Procurement and suppliers

Our procurement strategy is focused on strategic alliances with 60 key suppliers who account for the large majority of expenditure.

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 2014 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 2013 represented 27 days of the amount invoiced by suppliers during the year (2012: 28).

### Other information

#### • Political donations

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

#### • Incidents and prosecutions

Within the calendar year 2012 the company was the subject of 17 prosecution cases brought by the Environment Agency. These cases resulted in South West Water Limited being convicted of 42 offences (charges) with a total fine of £167,900.

Since 2010 the average number of charges brought by the EA has increased. The nature of charges brought now includes more technical offences in respect of reporting, maintenance and control system failures where such clauses exist in the permit, as well as the more typical offences in respect of breaches in discharge quality or discharges occurring outside of permit conditions.

## People and Community (continued)

- **Research and development**

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

## **Governance**

South West Water Limited is a wholly-owned subsidiary of Pennon Group PLC, a FTSE 250 company with shares listed on the London Stock Exchange. As a listed company, Pennon Group Plc (Pennon) is required to comply with the UK Corporate Governance Code, following both the spirit and the letter of the code.

South West Water itself has a fully-functioning and standalone Board. The business of the Board covers a full range of corporate issues including strategy, performance, delivery, compliance and governance.

The Board is responsible for ensuring effective governance and oversight of its operational business. The key areas include:

- reviewing the strategies, policies, management, initiatives and performance of South West Water particularly in regard to occupational health, safety and security, environment, workplace policies and non-financial regulatory compliance
- ensuring that South West Water conducts its business in a responsible manner in relation to environmental, social and governance (ESG) matters
- reviewing the accounting systems, internal controls and risk assessment processes operated by the company
- liaising with auditors in relation to the South West Water audit

South West Water has established its own appropriate committees which mirror the requirements of the UK Corporate Governance Code.

### **Board of Directors**

The South West Water Board of Directors at the end of the financial year comprised the Chairman (Non-executive), four Executive Directors, and two Non-executive Directors. The Board considers that the Chairman continues to be independent. Both of the two Non-executive Directors were considered by the Board to be independent throughout the year. They are considered by the Board to have the appropriate skills, experience in their respective disciplines and personality to bring independent and objective judgement to the Board's deliberations and to represent customers' interests.

The Chairman and Non-executive Directors take particular care to ensure that the Board considers the interests of customers in all matters discussed by the Board, reflecting a very real understanding of the particular pressures on South West Water's customers. In addition to a monthly review of customer contact and complaint analysis, the Board is also updated on customer satisfaction surveys. South West Water has monitored customer satisfaction with service and value for money quarterly for over 20 years, and has also facilitated focus groups to discuss local and regional investment. Findings from all methods of customer consultation are fed back to the Board and incorporated into company plans.

### **How the Board operates**

The Board has a schedule of matters reserved for its decision, and is also delegated matters for more detailed consideration from the Pennon Group PLC Board as appropriate. Written reports are circulated in advance of Board meetings from the Executive Directors on matters within their respective business areas. Under the guidance of the Chairman, all matters before the Board are discussed openly and presentations and advice are received frequently from Senior Managers or from external advisors.

### **Performance Evaluation**

The South West Water Board carried out an internally facilitated Board performance evaluation during the year. The results of the performance evaluation showed that the Board continued to operate effectively. The Board has confirmed that it intends to carry out a performance evaluation exercise on an annual basis.

## **Governance (continued)**

### **Dealing with Directors' conflicts of interest**

The Board has in place a procedure for the consideration and authorisation of Directors' conflicts or possible conflicts with the Company's interests. This is in accordance with the Directors' interests provisions of the Companies Act 2006 and the Company's Articles of Association with grants to Directors authority to approve such conflicts subject to appropriate conditions.

### **Internal Control**

As a wholly-owned subsidiary of Pennon Group PLC, South West Water adheres to the Pennon Group Risk Management Policy (GRMP) which provides for the key risks in relation to the achievement of the business objectives of the Group, monitoring of such risks and annual evaluation of the overall process as described in more detail below.

### **Risk Identification**

A full risk and control assessment is undertaken annually, and regularly updated, to identify both financial and non-financial risks. At each Board meeting details of any new high-level risks identified are presented together with how they are to be managed, in addition to details of any changes to existing risks and their management. All Executive Directors and senior managers are required to certify on an annual basis that they have effective controls in place to manage risks and to operate in compliance with legislation and procedures.

South West Water also adheres to the Pennon Group Plc Whistleblowing policy, and thoroughly investigates any allegations of misconduct and irregularity, whilst considering the implications for our control environment. In the normal course of business investigations into irregularities may be ongoing as of the date of the approval of the financial statements.

These processes all serve to ensure that South West Water has an embedded culture of effective control and risk management, and is positioned to be able to react appropriately to new risks as they arise. Details of the key risks affecting the Company are detailed in pages 26-31.

### **Internal Control Framework**

South West Water has a well-established internal control framework which is operated and applied in relation to the process for preparing the Company's financial statements and Annual Report.

This framework comprises

- a clearly defined structure which delegates an appropriate level of authority, responsibility and accountability to senior managers and their departments,
- a comprehensive budgeting and reporting function, with an annual budget approved by the Board, which also monitors the financial reporting process. Monthly performance and updated forecasts against budget for the full year are also provided,
- documented financial control procedures. As detailed above, senior managers are required to confirm annually that they have adequate financial controls in operation and to report any material financial risks. Compliance with procedures is reviewed and tested by the Pennon Group internal audit functions, internal quality assurance, external auditors and external ISO auditors,
- an investment appraisal process for evaluating proposals for all major capital expenditure and acquisitions, with defined levels of approval and a system for monitoring the progress of capital projects,
- a post-investment evaluation process for major capital expenditure to assess the success of the project and learn any lessons to be applied to future projects.

### **Internal Control Review**

An evaluation of the effectiveness of overall internal control compliance by South West Water is undertaken in respect of each financial year (and subsequently up to the date of this report) to assist the South West Water audit plan for the forthcoming financial year, and also the completion of the

## **Governance (continued)**

Annual Report Initial evaluation is carried out by senior managers for consideration and final evaluation by the Board

### **Going Concern**

The Company's solvency and liquidity risk profiles have been reviewed

Given the regulated nature of the business, and in particular a regulatory regime which supports (via a 25 year rolling Licence) a long-term sustainable business South West Water is well placed to respond to future events

Financial forecasts for the company are produced as part of a rigorous planning process, with comprehensive assessment of risks integral to the process, with sufficient cash and cash deposits and unutilised committed borrowing facilities available

Having considered the company's solvency and liquidity risk profile and 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

## Principal 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.

↔ Unchanged during the year    ↑ Increased during the year    ↓ Decreased during the year

RISK	COMMENTARY	MITIGATION
Regulatory		
Uncertainty arising from Regulatory Reform  ↑	2012/13 has seen the modification of company Licences in preparation for the next price review and a number of methodology change proposals  Defra issued its Strategic Policy Statement to Ofwat (the Economic Regulator) in March 2013, outlining direction and priorities. Within that context, Ofwat is reforming the regulatory approach.	South West Water has contributed fully to the consultation on regulatory reform, and has had dialogue with regulators and stakeholders in order to effectively portray its views. Methodology changes will continue to be considered over the coming months in the lead into the next price review.
Legislative & regulatory compliance  ↔	As a regulated business South West Water is subject to numerous and changing obligations with which we must comply. The company pays particular attention to management of risks in these areas.	Performance against key regulatory outputs is 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.  Internal monitoring and assurance programmes are undertaken through the year. Annual data is supported by external verification through the company auditors to provide assurance on the company's compliance with its obligations.
New regulations, obligations & standards could increase costs  ↔	Issues are addressed through the five year regulatory price review mechanism, obligations which arise within price control period such as Private Sewers and Bathing Water Obligations are funded through future adjustments to price limits.	SWW continues to manage cost pressures as they arise in addition to achieving operating cost efficiencies and managing inflationary increases.

## Principal Risks and Uncertainties

Economic conditions		
<p>Non-recovery of customer debt &amp; affordability</p> <p style="text-align: center;"></p>	<p>Customer debt and affordability are key areas of focus given the continued challenging economic conditions</p>	<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 through</p> <ul style="list-style-type: none"> <li>• use of third party collection agencies</li> <li>• external trace data to track down previous occupiers</li> <li>• developing a new strategy for previous and earlier debt collections</li> <li>• working with social housing partners</li> <li>• continued use of property charging orders</li> </ul> <p>The company 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>South West Water is one of the few companies to have implemented a social tariff following the introduction of its WaterCare tariff from 2013/14. This tariff is designed to assist around 10,000 households in the region by reducing their bills to an amount they can better afford to pay.</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 resulted in household customer's bill being reduced by £50 per annum from 2013/14.</p>
<p>Loss of revenue</p> <p style="text-align: center;"></p>	<p>South West Water revenue can be impacted by changes in customer demand and other income streams</p> <p>The company has c 76% of its customer base metered and as a result the revenue from main charges can be volatile from changes in customer usage which can be affected by</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 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 South West Water's other income streams are vulnerable to the downturn in economic activity, particularly in the property market affecting new connections, searches and other developer activity</p> <p>In addition the non-appointed area where growth is targeted is challenging</p>

## Principal Risks and Uncertainties

<p>Financial loss arising from insolvency of a major supplier</p> <p style="text-align: center;"></p>	<p>South West Water does not have material exposure to payment before receipt of goods and services</p>	<p>The company uses third party credit monitoring services to identify changes to major suppliers' financial status and creditworthiness to supplement an annual risk review of key and strategic supplier</p>
<p><b>Finance and funding</b></p>		
<p>The Company may be unable to raise sufficient funds to finance its functions</p> <p style="text-align: center;"></p>	<p>Access to finance and funding costs may be adversely affected by perceived credit rating and prolonged periods of market volatility or liquidity. There are covenant limits and restrictive obligations on borrowing and debt arrangements</p>	<p>Pennon Group and South West Water have robust treasury policies in place. These include policies that there are always pre-drawn or committed facilities to cover at least one year's estimated cashflow and that no more than 20% of borrowing matures in any one year. The company utilises a range of facilities including long and short term leases, loans and bonds.</p> <p>The Company is well placed for the funding requirements for the remainder of the K5 period</p>
<p>Pension costs may increase due to higher costs for future service growing deficits in relation to past service in the defined benefit schemes</p> <p style="text-align: center;"></p>	<p>All defined benefit schemes (apart from the Greater Manchester Waste PFI) have been closed to new entrants and replaced by defined contribution arrangements</p>	<p>Employee and employer contributions are kept under review and a formal actuarial valuation is being undertaken as at 31 March 2013</p> <p>Indications are that the actuarial deficit has increased since the last valuation in 2010</p> <p>Pension trustees keep investment policies under review and use professional investment advisers to target maximum investment returns</p>
<p><b>Operating Performance</b></p>		
<p>Non-compliance or avoidable H&amp;S incident occurs</p> <p style="text-align: center;"></p>	<p>South West Water is committed to achieving the appropriate level of health and safety compliance. This year has seen the continued delivery of the behavioural safety programme including safety leadership training for a number of staff and the use of a safety coach roles. In addition senior management visits are completed during the year across a number of sites</p>	<p>The number of RIDDOR accidents for 2012 has fallen by over 50% with 7 incidents reported in the year compared to 20 in 2011<sup>(1)</sup></p> <p>Continuous training is being provided ensure that appropriate health and safety working practises are embedded and this reducing trend continues</p> <p><sup>(1)</sup> Criteria for RIDDOR reporting has changed in 2012. The number of incidents in 2011 would be restated to 16 if changes in RIDDOR reporting were applied to the prior year</p>

## Principal Risks and Uncertainties

<p>Operational failure at clean and waste water sites</p> <p style="text-align: center;"></p>	<p>Due to the nature of South West Water's business there are continued risks arising during the normal course of business, including risk of failure of 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.</p> <p>Where issues do arise there are appropriate contingency plans to deal with such instances and these are updated through experiences of such events.</p>
<p>Contamination of water supplies</p> <p style="text-align: center;"></p>	<p>South West Water has established procedures and controls in place, as well as contingency plans and incident management procedures.</p>	<p>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.</p>
<p>Extreme weather and climate change</p> <p style="text-align: center;"></p>	<p>2012 has been a challenging year in terms of weather impacts. The continued dry weather from 2011 into the early part of 2012 placed pressure on our water resources. This was followed by a period of extreme rain – our wettest Spring/Summer in 100 years which placed significant pressure on our network and resulted in higher levels of flooding incidents.</p>	<p>The business is well placed to manage such extreme incidents. Key mitigation is having detailed contingency plans, sufficient emergency resources and a capital programme that supports ongoing efforts to manage these risks. In the longer term the impacts of climate change are being considered. 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.</p>
<p>Pollution events</p> <p style="text-align: center;"></p>	<p>South West Water is committed to minimising the impact on the environment.</p>	<p>As a result of the extreme weather during the year the number of acute pollution incidents has increased from the prior year. Whilst this is regrettable the number of more serious incidents has fallen from the prior year.</p>

## Principal Risks and Uncertainties

<p>Water resources adequacy</p> <p style="text-align: center;"></p>	<p>South West Water 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>Whilst there has been a strong recovery in our water resources, as a result of the extremely wet weather seen over spring/summer 2012, the company continues to monitor reservoir levels to maintain sufficient water resources for the drier periods seen in recent years</p> <p>South West Water also considers the longer term resource situation. It prepares a new Water Resources Management Plan every five years and reviews it annually for a range of climate change and demand scenarios. The Draft Water Resources Management Plan for 2015-2040 has recently been published. The plan indicates that the company has a surplus of resources through to the horizon of 2040. However, investment is needed to develop the overall trunk main infrastructure, to expand treatment capacity and to enhance certain pumped storage facilities.</p>
<p>Poor service provided to customers</p> <p style="text-align: center;"></p>	<p>Customer service remains paramount to South West Water and the company focuses on improving customer satisfaction and reducing customer complaints</p>	<p>The company has delivered significant improvements in customer service during K5 with a 51% reduction in written complaints and 88% increase in the Service Incentive Mechanism (SIM) score. The continued improvement is being targeted.</p>
	<p>South West Water could incur a financial penalty under Ofwat's Service Incentive Mechanism (SIM) for below average customer service performance</p>	<p>While the company has seen improvements in customer service particularly through reduced written complaints, there remains uncertainty over South West Water's relative position in the industry and there is a continued strategy for 2013/14 in place to improve customer service further.</p>
<p>Failure to deliver operating cost efficiencies</p> <p style="text-align: center;"></p>	<p>In line with its track record, South West Water remains confident of delivering the assumed operating cost savings</p>	<p>The company has delivered cumulative operating cost efficiencies ahead of K5 targets</p>
<p><b>Capital Investment</b></p>		
<p>Failure to plan and deliver the capital improvement programme</p> <p style="text-align: center;"></p>	<p>South West Water may not carry out its capital programme within the price limits and with the efficiencies determined by Ofwat</p>	<p>South West Water has a track record of delivering its capital programme in accordance with regulatory requirements and progress is regularly monitored and reviewed</p>

## Principal Risks and Uncertainties

Market		
<p>Uncertainty arising from market reform</p> <p style="text-align: center;">↑</p>	<p>Whilst the Draft Water Bill recognised an approach to reform that was 'evolutionary' rather than 'revolutionary' the development of greater competition in the water industry could reduce South West Water's revenues</p>	<p>As part of the risk management and business strategic planning processes the company continues to evaluate developments and proposals for competition</p> <p>South West Water is prepared for the development of retail competition for non-household customers during the next regulatory period and has developed enhanced services offered to commercial customers through Source for Business</p>
Business Systems		
<p>Major failure of corporate IT systems</p> <p style="text-align: center;">↔</p>	<p>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's business</p>	<p>South West Water has well developed IT systems and continuity systems in place. These include a geographically separate alternative data centre, which is hosted by a third party communications provider, reducing the impact of any failure or disruption</p>
Reputation		
<p>Loss of key stakeholder support and prolonged negative media campaign</p> <p style="text-align: center;">↔</p>	<p>South West Water has a number of key stakeholders and aims to balance their needs (including our customers) with environmental responsibilities and legislative and regulatory obligations</p>	<p>The company is committed to engaging with key stakeholders for both our long term strategy and coming regulatory period through our independently chaired WaterFuture Customer Panel which includes representatives from stakeholder organisations</p> <p>In addition South West Water actively manages communications with customers and stakeholders both online and through social media</p>

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### 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 and 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
Secretaries	K D Woodier M L Heeley R C Zmuda
Registered Office	Peninsula House Rydon Lane Exeter Devon EX2 7HR
Auditors	PricewaterhouseCoopers LLP Chartered Accountants and Statutory Auditors 31 Great George Street Bristol BS1 5QD
The company's registered number	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. 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,
- 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.

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

(a) so far as the director is aware, there is no relevant audit information of which the company's auditors are unaware, and

(b) he has taken all the steps that he ought to have taken as a director in order to make himself aware of any relevant audit information and to establish that the company's auditors are aware of that information

## Annual General Meeting

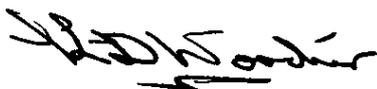
The twenty-fourth Annual General Meeting of South West Water Limited will be held at Peninsula House, Rydon Lane, Exeter on 16 July 2013 for the transaction of the following business

- Resolution 1            To receive the Report of the Directors and the audited financial statements for the year ended 31 March 2013
- 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

For the purposes of the appointment of auditors (Resolution 2 in this notice), Special notice in accordance with Sections 312 and 485(3), Companies Act 2006 of the intention to move Resolution 2 as an ordinary resolution has been received by the Company

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

By Order of the Board



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

10 July 2013

# **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 2013 which comprise the Income Statement, the Statement of Comprehensive Income, the Statement of Changes in Equity, the Balance Sheet, the Cash Flow Statement, the Accounting Policies and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

## **Respective responsibilities of directors and auditors**

As explained more fully in the Directors' Responsibilities Statement set out on page 33, 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 2013 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.

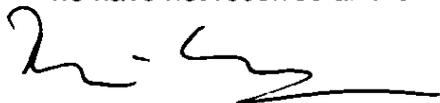
## **Matters on which we are required to report by exception**

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

## Independent Auditors' Report To The Members Of South West Water Limited

- 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  
10 July 2013

## Income statement for the year ended 31 March 2013

	Note	2013 £m	2012 £m
<b>Revenue</b>		<b>500.1</b>	474.7
<b>Operating costs</b>	6		
Manpower costs (excluding restructuring costs)		(38.3)	(36.5)
Raw materials and consumables used		(14.7)	(14.4)
Other operating expenses		(129.1)	(116.1)
Depreciation		(102.3)	(100.5)
Restructuring costs	25	(0.5)	(2.5)
<b>Operating profit</b>		<b>215.2</b>	204.7
Finance costs	7	(88.9)	(122.4)
Finance income	7	25.7	59.1
Net finance costs before exceptional item		(63.2)	(63.3)
Exceptional item	5	12.5	-
<b>Profit before tax</b>		<b>164.5</b>	141.4
Taxation	8	(30.7)	(11.9)
<b>Profit for the year</b>		<b>133.8</b>	129.5

The notes on pages 42 to 80 form part of these financial statements

## Statement of comprehensive income for the year ended 31 March 2013

	Note	2013 £m	2012 £m
<b>Profit for the year</b>		<b>133.8</b>	129.5
Actuarial losses on defined benefit schemes	23	(10.4)	(37.5)
Cash flow hedges			
Net fair value losses		(7.9)	(25.7)
Exceptional item	5	2.9	-
Deferred tax (charge)/credit on items taken directly to equity	24	(0.7)	12.3
<b>Total other comprehensive expense</b>		<b>(16.1)</b>	(50.9)
<b>Total comprehensive income for the year</b>		<b>117.7</b>	78.6

The notes on pages 42 to 80 form part of these financial statements

## Statement of changes in equity for the year ended 31 March 2013

	Note	Called up share capital £m	Retained earnings and other reserves £m	Total Equity £m
At 1 April 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	9	-	(77.9)	(77.9)
Share based payments	27 & 28	-	1.1	1.1
Total transactions with equity shareholders		-	(76.8)	(76.8)
At 31 March 2012		150.9	343.2	494.1
Profit for the year		-	133.8	133.8
Other comprehensive expense for the year		-	(16.1)	(16.1)
Total comprehensive income for the year		-	117.7	117.7
<b>Transactions with equity shareholders</b>				
Dividends paid	9	-	(133.0)	(133.0)
Share based payments	27 & 28	-	1.3	1.3
Total transactions with equity shareholders		-	(131.7)	(131.7)
<b>At 31 March 2013</b>		<b>150.9</b>	<b>329.2</b>	<b>480.1</b>

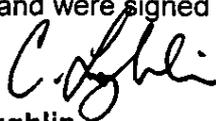
The notes on pages 42 to 80 form part of these financial statements

## Balance sheet at 31 March 2013

	Note	2013 £m	2012 £m
<b>Assets</b>			
<b>Non-current assets</b>			
Property, plant and equipment	12	2,555.3	2,541.1
Investment in subsidiary undertakings	15	3.3	3.3
Investment in joint venture	15	0.1	0.1
Trade and other receivables	14	0.4	1.0
		<u>2,559.1</u>	<u>2,545.5</u>
<b>Current assets</b>			
Inventories	16	3.8	3.7
Trade and other receivables	17	101.8	85.3
Cash and cash deposits	19	234.4	293.6
		<u>340.0</u>	<u>382.6</u>
<b>Liabilities</b>			
<b>Current liabilities</b>			
Borrowings	21	(53.4)	(68.7)
Derivative financial instruments	18	(20.0)	(13.5)
Trade and other payables	20	(87.2)	(81.2)
Current tax liabilities		(49.6)	(32.2)
Provisions for liabilities and charges	25	(3.2)	(3.7)
		<u>(213.4)</u>	<u>(199.3)</u>
<b>Net current assets</b>			
		<u>126.6</u>	<u>183.3</u>
<b>Non-current liabilities</b>			
Borrowings	21	(1,781.4)	(1,809.8)
Other non-current liabilities	22	(63.5)	(61.2)
Derivative financial instruments	18	(31.1)	(29.6)
Retirement benefit obligations	23	(86.6)	(77.9)
Deferred tax liabilities	24	(243.0)	(256.2)
		<u>(2,205.6)</u>	<u>(2,234.7)</u>
<b>Net assets</b>			
		<u>480.1</u>	<u>494.1</u>
<b>Shareholders' equity</b>			
Called up share capital	26	150.9	150.9
Retained earnings and other reserves	28	329.2	343.2
<b>Total shareholders' equity</b>		<u>480.1</u>	<u>494.1</u>

The notes on pages 42 to 80 form part of these financial statements

The financial statements on pages 37 to 80 were approved by the Board of Directors on 10 July 2013 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 2013

	Note	2013 £m	2012 £m
<b>Cash flows from operating activities</b>			
Cash generated from operations	29	307.4	269.1
Interest paid		(63.0)	(57.7)
Tax paid		(34.0)	(28.5)
<b>Net cash generated from operating activities</b>		<b>210.4</b>	<b>182.9</b>
<b>Cash flows from investing activities</b>			
Interest received		1.4	3.8
Exceptional item	5	15.4	-
Receipt of grants and contributions		1.0	1.6
Purchase of property, plant and equipment		(111.9)	(138.7)
Proceeds from sale of property, plant and equipment		1.6	1.3
<b>Net cash used in investing activities</b>		<b>(92.5)</b>	<b>(132.0)</b>
<b>Cash flows from financing activities</b>			
Deposit of restricted funds		(25.3)	(26.9)
Repayment of borrowings		(21.1)	(36.1)
Finance lease sale and leaseback		85.5	65.0
Finance lease principal repayments		(95.3)	(4.0)
Dividends paid		(133.0)	(77.9)
<b>Net cash used in financing activities</b>		<b>(189.2)</b>	<b>(79.9)</b>
<b>Net decrease in cash and cash equivalents</b>		<b>(71.3)</b>	<b>(29.0)</b>
Cash and cash equivalents at beginning of the year	19	169.8	198.8
<b>Cash and cash equivalents at end of the year</b>	19	<b>98.5</b>	<b>169.8</b>

The notes on pages 42 to 80 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 32. The nature of the Company's operations and its principal activities are set out in the Directors' report on page 4.

These financial statements were approved by the Board of Directors on 10 July 2013.

## 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 interpretations of the IFRS Interpretations Committee (IFRIC) 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 25.

New or revised standards or interpretations which were mandatory for the first time in the year beginning 1 April 2012 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 (Revised) 'Employee Benefits' on 1 April 2013, will have a material impact on the financial statements of the Company. In the year to 31 March 2014 the revised standard is expected to result in a net finance cost in the region of around £2m, and a further £1m is expected to be charged to operating profit to recognise administration costs as they are incurred. Pension liabilities will reduce by approximately £8m as at 31 March 2013 as a result of the change.

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.

### (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.

## Notes To The Financial Statements (continued)

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, Devon, 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 country of domicile is the United Kingdom and is the country in which it generates all of its revenue. The Company's non-current assets are all located 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.

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

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

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

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

Other assets are included at cost less accumulated depreciation.

## Notes To The Financial Statements (continued)

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

Freehold buildings	30 – 60 years
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.

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.

## Notes To The Financial Statements (continued)

### (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

### (m) Derivatives and other financial instruments

The Company classifies its financial instruments in the following categories

#### *1) 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

## Notes To The Financial Statements (continued)

### *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.

### *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.

## Notes To The Financial Statements (continued)

### 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 the 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.

The Company is part of the Pennon Group for tax purposes and accordingly may use the tax group relief provisions whereby current tax liabilities can be offset by current tax losses arising in other companies within the same tax group. Payment for group relief is made equal to the tax benefit and amounts are included within the current tax disclosures.

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.

### (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.

## Notes To The Financial Statements (continued)

### *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.

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.

## Notes To The Financial Statements (continued)

used to provide the ongoing service

### (t) Exceptional items

Exceptional items are those that in the Directors' view are required to be separately disclosed by virtue of their size or incidence to enable a full understanding of the Company's financial performance

## 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 58% 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 18.

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

At 31 March 2013, 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/increased by £0.3m (2012: £0.3m).

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 £1.4m (2012: £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 21.

## Notes To The Financial Statements (continued)

Contractual undiscounted cash flows were

### 31 March 2013

	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	21 1	31 1	93 3	1,237 5	1,383 0
Interest payments on borrowing	9 2	9 3	28 4	617 7	664 6
Finance lease liabilities	47 4	56 7	209 6	2,038 8	2,352 5
<b>Derivative financial liabilities</b>					
Derivative contracts – net payments	19 1	26 3	26 3	8 6	80 3

### 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 4	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

### 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 17.

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

## Notes To The Financial Statements (continued)

borrowings as shown in the 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 2013 and 2012 were as follows

	2013	2012
	£m	£m
Net Borrowings (note 30)	1,600.4	1,584.9
Total equity	480.1	494.1
Total capital	<u>2,080.5</u>	<u>2,079.0</u>
Gearing Ratio	<u>76.9%</u>	<u>76.2%</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.

	2013	2012
	£m	£m
Regulatory Capital Value	2,915.7	2,826.8
Net Borrowings (note 30)	1,600.4	1,584.9
Net Debt / Regulatory Capital Value	<u>55%</u>	<u>56%</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)

The disclosures are set out in note 18.

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

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

## Notes To The Financial Statements (continued)

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

#### (a) 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.

#### (b) 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 2013 the Company's current trade receivables were £108.6m, before the provision for impairment.

#### (c) 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 23 of the financial statements.

#### (d) Taxation

The Company's current tax provision of £49.6m 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.

## Notes To The Financial Statements (continued)

### **(e) 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 23 to these financial statements

### **(f) Property, plant and equipment**

The Company's accounting policy for property, plant and equipment is detailed in note 2 (e) of the financial statements. The carrying value of property, plant and equipment as at 31 March 2013 was £2,555.3m. In the year ended 31 March 2013 additions to property, plant and equipment totalled £116.5m and the depreciation charge was £104.4m. 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.

### **(g) 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.

## Notes To The Financial Statements (continued)

### 5. Exceptional Item

	2013 £m	2012 £m
<b>Net finance costs:</b>		
Receipt on transfer and subsequent termination of lease	15.4	-
Fair value loss on associated interest rates swap transferred from equity on termination of lease	(2.9)	-
<b>Profit on exceptional item before tax</b>	<b>12.5</b>	<b>-</b>
<b>Tax arising on exceptional item:</b>		
- current tax	(3.7)	-
- deferred tax	0.7	-
	<b>(3.0)</b>	<b>-</b>
<b>Profit after tax on exceptional item</b>	<b>9.5</b>	<b>-</b>

The Company received a consent fee related to the transfer and subsequent termination of lease arising from the sale of a finance lease between financial institutions

### 6. Operating costs

	2013 £m	2012 £m
Manpower costs (note 10)	38.3	36.5
Raw materials and consumables	14.7	14.4
<b>Other operating expenses include</b>		
Profit on disposal of property, plant and equipment	(1.4)	(1.1)
Operating lease rentals payable		
- plant and machinery	1.1	1.3
- property	1.4	1.5
Research and development expenditure	0.2	0.2
Trade receivables impairment (note 17)	9.5	8.5
Depreciation of property, plant and equipment		
- owned assets	69.6	71.8
- under finance leases	32.7	28.7
	<b>102.3</b>	<b>100.5</b>

## Notes To The Financial Statements (continued)

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

	2013 £000	2012 £000
Fees payable for the audit of the financial statements	123	125
Fees payable for other services		
- Audit related assurance services	68	29
- Tax advisory services	146	99
- Other non-audit services	172	102
	<u>509</u>	<u>355</u>

Expenses reimbursed to the auditors in relation to the audit of the Company were £12,000 (2012 £14,000)

### 7. Net finance costs

	2013			2012		
	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	(8.3)	-	(8.3)	(7.3)	-	(7.3)
Interest element of finance lease rentals	(39.9)	-	(39.9)	(37.8)	-	(37.8)
Other finance costs	(3.7)	-	(3.7)	(4.7)	-	(4.7)
Interest receivable	-	3.4	3.4	-	3.3	3.3
Intercompany interest to subsidiaries	(16.6)	-	(16.6)	(20.1)	-	(20.1)
	<u>(68.5)</u>	<u>3.4</u>	<u>(65.1)</u>	<u>(69.9)</u>	<u>3.3</u>	<u>(66.6)</u>
<b>Other finance income</b>						
Fair value losses on derivative financial instruments providing commercial hedges	-	-	-	(31.9)	-	(31.9)
Investment income received	-	-	-	-	33.6	33.6
	<u>-</u>	<u>-</u>	<u>-</u>	<u>(31.9)</u>	<u>33.6</u>	<u>1.7</u>
<b>Notional interest</b>						
Retirement benefit obligations (note 23)	(20.4)	22.3	1.9	(20.6)	22.2	1.6
	<u>(88.9)</u>	<u>25.7</u>	<u>(63.2)</u>	<u>(122.4)</u>	<u>59.1</u>	<u>(63.3)</u>

Other finance income represents enhanced yields from investment income received on deposits held partially offset by fair value losses on derivative financial instruments which provided commercial hedges against these short-term structured deposits. These transactions commenced and matured during the year.

## Notes To The Financial Statements (continued)

### 8. Taxation

	2013 £m	2012 £m
<b>Analysis of charge in year</b>		
UK corporation tax	44.6	27.7
Deferred tax - arising on change of rate of corporation tax (note 23)	(12.3)	(24.2)
Deferred tax - other	(1.6)	8.4
	<u>(13.9)</u>	<u>(15.8)</u>
<b>Total charge for the year</b>	<u>30.7</u>	<u>11.9</u>

UK corporation tax is calculated at 24% (2012 26%) of the estimated assessable profit for the year

The deferred tax credit for the year is increased by a non-recurring credit of £12.3m (2012 £24.2m) arising from a 1% (2012 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 of 24% (2012 26%) The differences are explained below

	2013 £m	2012 £m
Profit before tax	<u>164.5</u>	141.4
Profit before tax multiplied by the standard rate of corporation tax in the UK of 24% (2012 26%)	39.5	36.8
Effects of		
Expenses not deductible for tax purposes	1.1	1.1
Adjustments to tax charge in respect of prior year	2.7	(2.0)
Change in rate of corporation tax	(12.3)	(24.2)
Other	(0.3)	0.2
<b>Tax charge for year</b>	<u>30.7</u>	<u>11.9</u>

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 19% (2012 8%)

The company reimburses other Group companies for losses claimed by way of group relief at an amount equal to the tax benefit received The UK Corporation tax charge for the year includes estimated amounts payable in respect of Group relief for the year of £22.1m (2012 £6.8)

## Notes To The Financial Statements (continued)

In addition to the amount credited to the income statement, a deferred tax credit relating to actuarial losses on defined benefit schemes of £2.5m (2012 £10.0m) has been charged directly to equity. A deferred tax debit relating to hedging reserve movements of £1.3m (2012 £5.0m) has been charged to equity. Deferred tax recognised directly to equity relating to share-based payments were £0.2m (2012 £nil).

### 9. Dividends

	2013 £m	2012 £m
Amounts recognised as distributions to equity holders in the year		
Base dividend of 41.7p per ordinary share in respect of 2011/12 paid 29 September 2011	-	62.9
Dividend of 9.9p per ordinary share in respect of outperformance for 2010/11 paid 29 September 2011	-	15.0
Dividend of 25.9p per ordinary share in respect of outperformance for 2011/12 paid 27 September 2012	39.1	-
Base dividend of 43.6p per ordinary share in respect of 2012/13 paid 27 September 2012	65.8	-
Dividend of 18.6p per ordinary share in respect of outperformance for 2012/13 paid 27 September 2012	28.1	-
	<b>133.0</b>	<b>77.9</b>

### 10. Employment costs

The average number of persons (including Directors) employed by the Company was 1,163 (2012 1,182).

	2013 £m	2012 £m
Employment costs comprise		
Wages and salaries	34.4	34.2
Social security costs	3.1	2.8
Pension costs	8.4	8.9
Share-based payments	1.2	1.1
Total employment costs	<b>47.1</b>	<b>47.0</b>
Charged as follows		
Manpower costs	38.3	36.5
Capital schemes	8.6	8.2
Restructuring provision	0.2	2.3
Total employment costs	<b>47.1</b>	<b>47.0</b>

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

## Notes To The Financial Statements (continued)

### 11. Directors' emoluments

	2013 £000	2012 £000
Total emoluments of the Directors of the Company		
Salary	734	702
Fees (non-executive Directors)	70	60
Performance-related bonus paid or payable	226	266
Share-based payments	623	582
Other emoluments	184	178
Total emoluments	<u>1,837</u>	<u>1,788</u>

The cost of share-based payments represents the amount charged to the income statement, as described in note 27

The aggregate gains on vesting of Directors' share-based awards amounted to a total of £963,000

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

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 attributable to the Company of the highest paid Director were £498,637 (2012 £517,000)

At 31 March 2013 retirement benefits were accruing to three Directors (2012 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 (continued)

### 12. 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 2011	21.3	1,456.3	622.3	1,105.5	95.8	3,301.2
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>
Additions	0.1	11.6	1.4	25.0	78.4	116.5
Assets adopted at fair value	-	3.3	-	-	-	3.3
Grants & contributions	-	(1.0)	-	-	-	(1.0)
Disposals	-	(1.2)	-	(2.7)	-	(3.9)
Transfers/reclassifications	1.0	16.9	10.6	46.4	(74.9)	-
<b>At 31 March 2013</b>	<b>23.4</b>	<b>1,559.0</b>	<b>641.1</b>	<b>1,253.1</b>	<b>112.7</b>	<b>3,589.3</b>
<b>Accumulated depreciation:</b>						
At 1 April 2011	4.7	101.4	174.0	553.3	-	833.4
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>
Charge for year	0.5	23.0	11.2	69.7	-	104.4
Disposals	-	(1.2)	-	(2.5)	-	(3.7)
<b>At 31 March 2013</b>	<b>5.8</b>	<b>144.5</b>	<b>196.3</b>	<b>687.4</b>	<b>-</b>	<b>1,034.0</b>
<b>Net book value:</b>						
<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>
<b>At 31 March 2013</b>	<b>17.6</b>	<b>1,414.5</b>	<b>444.8</b>	<b>565.7</b>	<b>112.7</b>	<b>2,555.3</b>

Out of the total depreciation charge for the Company of £104.4m (2012 £102.4m), the sum of £1.3m (2012 £1.4m) has been charged to capital projects, £0.8m (2012 £0.5m) has been offset by deferred income and £102.3m (2012 £100.5m) 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 (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 2012	-	357.0	465.2	365.5	0.3	1,188.0
<b>At 31 March 2013</b>	-	<b>357.0</b>	<b>465.2</b>	<b>370.8</b>	<b>0.3</b>	<b>1,193.3</b>
<b>Accumulated depreciation</b>						
At 31 March 2012	-	31.3	97.0	167.6	-	295.9
<b>At 31 March 2013</b>	-	<b>36.6</b>	<b>104.9</b>	<b>157.1</b>	-	<b>298.6</b>
<b>Net book amount</b>						
At 31 March 2012	-	325.7	368.2	197.9	0.3	892.1
<b>At 31 March 2013</b>	-	<b>320.4</b>	<b>360.3</b>	<b>213.7</b>	<b>0.3</b>	<b>894.7</b>

### 13. Financial instruments by category

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

	Note	Fair value	Amortised cost		Total £m
		Derivatives £m	Loans and receivables £m	Trade receivables and trade payables £m	
<b>31 March 2013</b>					
<b>Financial assets</b>					
Trade and other receivables	14 & 17	-	3.9	36.1	40.0
Cash and cash deposits	19	-	234.4	-	234.4
		-	238.3	36.1	274.4
<b>Financial liabilities</b>					
Borrowings	21	-	(1,834.8)	-	(1,834.8)
Derivative financial instruments	18	(51.1)	-	-	(51.1)
Trade and other payables	20	-	(3.8)	(46.6)	(50.4)
		(51.1)	(1,838.6)	(46.6)	(1,936.3)

## Notes To The Financial Statements (continued)

	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	14 & 17	-	9.3	13.3	22.6
Cash and cash deposits	19	-	293.6	-	293.6
		-	302.9	13.3	316.2
<b>Financial liabilities</b>					
Borrowings	21	-	(1,878.5)	-	(1,878.5)
Derivative financial instruments	18	(43.1)	-	-	(43.1)
Trade and other payables	20	-	(29.0)	(45.4)	(74.4)
		(43.1)	(1,907.5)	(45.4)	(1,996.0)

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

	2013 £m	2012 £m
Amounts owed by subsidiary company	0.4	1.0

The effective interest rate on amounts owed by subsidiary is 2.3% (2012 2.3%)

### 15. Investments

	2013 £m	2012 £m
At 31 March		
Subsidiary undertakings	3.3	3.3
Joint venture	0.1	0.1

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.

At the year end the Company held 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.

Subsequent to the year end the Company's holding of Echo South West Limited was reduced to 2 A ordinary shares, the Board of Echo South West Limited has been authorised by its members to submit an application to the Registrar of Companies to request the strike off and removal of the Company from the register of companies.

## Notes To The Financial Statements (continued)

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

### 16. Inventories

	2013 £m	2012 £m
Raw materials and consumables	3.8	3.7

### 17. Trade and other receivables - current

	2013 £m	2012 £m
Trade receivables	108.6	76.3
Less provision for impairment of receivables	(72.5)	(63.0)
Net trade receivables	36.1	13.3
Amounts owed by subsidiary companies	1.1	0.2
Amounts owed by fellow subsidiary companies	1.2	1.0
Other receivables	1.2	7.1
Prepayments and accrued income	62.2	63.7
	101.8	85.3

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.

The ageing of gross trade receivables past due but not specifically impaired was

	2013 £m	2012 £m
Past due 1 - 30 days	22.8	10.2
Past due 31 - 120 days	10.5	9.7
Past due more than 120 days	110.5	94.5

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.

## Notes To The Financial Statements (continued)

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

	2013 £m	2012 £m
At 1 April	63.0	54.5
Provision for receivables impairment	9.5	8.5
Receivables written-off during the year as uncollectable	(9.1)	(6.6)
Cumulative amounts previously excluded from debt	9.1	6.6
At 31 March	<u>72.5</u>	<u>63.0</u>

### 18. Derivative financial instruments

	2013 £m	2012 £m
<i>Derivatives used for cash flow hedging</i>		
Current liabilities	(18.6)	(13.5)
Non-current liabilities	(29.6)	(29.6)
<i>Derivatives deemed held for trading</i>		
Current liabilities	(1.4)	-
Non-current liabilities	(1.5)	-

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

The ineffective portion recognised in the income statement arising from cash flow hedges was £nil (2012: £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 2013, 58% (2012: 67%) of net borrowings was at fixed rate.

At 31 March 2013 interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £1,135.0m existed, with a weighted average maturity of 4.1 years (2012: £705.0m, with 3.3 years). The weighted average interest rate of the swaps was 2.7% (2012: 3.2%).

## Notes To The Financial Statements (continued)

### Valuation hierarchy

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

	2013 £m	2012 £m
Level 2 inputs		
<b>Liabilities</b>		
Derivatives used for cash flow hedging	48.2	43.1
Derivatives deemed held for trading	2.9	-
<b>Total liabilities</b>	<b>51.1</b>	<b>43.1</b>

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.

### 19. Cash and cash deposits

	2013 £m	2012 £m
Cash at bank and in hand	33.5	-
Overnight deposits	-	20.0
Other short-term deposits	65.1	165.1
Other deposits	135.8	108.5
	<b>234.4</b>	<b>293.6</b>

Other deposits include £135.8m (2012: £108.5m) of restricted funds to settle long-term lease liabilities (note 21).

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

	2013 £m	2012 £m
Cash and cash deposits as above	234.4	293.6
Bank overdrafts (note 21)	-	(15.3)
	<b>234.4</b>	<b>278.3</b>
Less deposits with a maturity of three months or more	<b>(135.9)</b>	<b>(108.5)</b>
<b>Cash and cash equivalents</b>	<b>98.5</b>	<b>169.8</b>

## Notes To The Financial Statements (continued)

### 20. Trade and other payables - current

	2013 £m	2012 £m
Trade payables	46.6	45.4
Amounts owed to parent undertaking	0.7	5.4
Amounts owed to subsidiary companies	3.2	3.3
Amounts owed to fellow subsidiaries	-	2.8
Other tax and social security	10.3	1.2
Other payables	6.8	4.4
Accruals	18.7	17.8
Deferred income	0.9	0.9
	<u>87.2</u>	<u>81.2</u>

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

### 21. Borrowings

	2013 £m	2012 £m
<b>Current</b>		
Bank overdrafts	-	15.3
European Investment Bank	21.1	21.1
	<u>21.1</u>	<u>36.4</u>
Obligations under finance leases	32.3	32.3
<b>Total current borrowings</b>	<u>53.4</u>	<u>68.7</u>
<b>Non-current</b>		
European Investment Bank	210.4	231.5
Loan from subsidiary company	379.8	372.6
	<u>590.2</u>	<u>604.1</u>
Obligations under finance leases	1,191.2	1,205.7
	<u>1,781.4</u>	<u>1,809.8</u>
<b>Total borrowings</b>	<u>1,834.8</u>	<u>1,878.5</u>

The loan from subsidiary company represents a loan from South West Water Finance Plc, a UK company whose purpose is to raise borrowings for South West Water Limited. The borrowings raised are lent to the Company on 'back to back' terms.

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

## Notes To The Financial Statements (continued)

The fair value of the non-current borrowings were

	2013		2012	
	Book value £m	Fair value £m	Book value £m	Fair Value £m
European Investment Bank	210.4	189.5	231.5	205.7
Loan from subsidiary company	379.8	341.8	372.6	299.3
	<b>590.2</b>	<b>531.3</b>	<b>604.1</b>	<b>505.0</b>
Obligations under finance leases	1,191.2	1,022.8	1,205.7	1,050.4
	<b>1,781.4</b>	<b>1,554.1</b>	<b>1,809.8</b>	<b>1,555.4</b>

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

	2013 £m	2012 £m
Between 1 and 2 years	66.2	47.8
Over 2 and less than 5 years	232.4	231.9
Over 5 years	1,482.8	1,530.1
	<b>1,781.4</b>	<b>1,809.8</b>

Finance lease liabilities - minimum lease payments

	2013 £m	2012 £m
Within 1 year	47.4	55.4
Over 1 year and less than 5 years	266.3	266.5
Over 5 years	2,038.8	2,203.1
	<b>2,352.5</b>	<b>2,525.0</b>
Less future finance charges	(1,129.0)	(1,287.0)
	<b>1,223.5</b>	<b>1,238.0</b>

## Notes To The Financial Statements (continued)

The maturity of finance lease liabilities was

	2013 £m	2012 £m
Within 1 year	32.3	32.3
Over 1 year and less than 5 years	174.2	165.3
Over 5 years	1,017.0	1,040.4
	<u>1,223.5</u>	<u>1,238.0</u>

Included above are accrued finance charges arising on obligations under finance leases totalling £130.8m (2012 £135.5m), of which £14.3m (2012 £12.6m) is repayable within one year

Included above is £0.7m (2012 £0.7m) due to Peninsula Leasing Limited, a subsidiary company, under finance lease agreements of which £0.4m (2012 £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

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 £52.4m at 31 March 2013 (2012 £41.9m) are being held to settle the lease liability over the period from the end of the original lease term. The deposits are subject to a registered charge given as security to the lessor for the balance outstanding.

The 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 2013 of £83.5m (2012 £66.6m) is being held to settle the lease liability at the end of the lease term, subject to rights to release by negotiation with the lessor.

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

	2013 £m	2012 £m
Floating rate		
Expiring within one year	-	35.0
Expiring after one year	105.0	105.0
	<u>105.0</u>	<u>140.0</u>

In addition, the company has short-term uncommitted bank facilities of £25.0m (2012 £50.0m)

### 22. Other non-current liabilities

	2013 £m	2012 £m
Other payables and deferred income	<u>63.5</u>	<u>61.2</u>

## Notes To The Financial Statements (continued)

### 23. 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 £0.4m (2012: £0.3m)

#### Defined benefit schemes

The principal actuarial assumptions at the balance sheet date were

	2013	2012
	%	%
Rate of increase in pensionable pay	3.4	3.5
Rate of increase for current and future pensions	3.4	3.3
Rate used to discount schemes' liabilities	4.4	4.7
Inflation	3.4	3.3

For 2013/14 the revised IAS 19 will be implemented which requires the expected return on schemes' assets to be the same as the rate used to discount liabilities.

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.

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

	2013	2012
Male	25.0	24.9
Female	27.0	27.0

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

	2013	2012
Male	25.9	25.8
Female	28.3	28.2

## Notes To The Financial Statements (continued)

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

	<b>Change in assumption</b>	<b>Impact on schemes' liabilities</b>
Rate of increase in pensionable pay	+/- 0.5%	+/- 1.3%
Rate of increase in current and future pensions	+/- 0.5%	+/- 6.6%
Rate used to discount schemes' liabilities	+/- 0.5%	+/- 9.2%
Inflation	+/- 0.5%	+/- 8.3%
Life expectancy	+/- 1 year	+/- 3.6%

The amounts recognised in the income statement were	<b>2013</b>	<b>2012</b>
	<b>£m</b>	<b>£m</b>
Current service cost	(7.9)	(7.4)
Past service cost	(0.3)	(0.7)
<b>Total included within operating costs</b>	<b>(8.2)</b>	<b>(8.1)</b>
Expected return on pension schemes' assets	22.3	22.2
Interest cost on retirement benefit obligations	(20.4)	(20.6)
<b>Total included within net finance costs</b>	<b>1.9</b>	<b>1.6</b>
<b>Total charge</b>	<b>(6.3)</b>	<b>(6.5)</b>

The actual return on schemes' assets was an increase of £48.4m (2012 increase of £24.5m)

The amounts recognised in the statement of comprehensive income were	<b>2013</b>	<b>2012</b>
	<b>£m</b>	<b>£m</b>
Actuarial loss recognised in the year	(10.4)	(37.5)

The amounts recognised in the balance sheet were	<b>2013</b>	<b>2012</b>
	<b>£m</b>	<b>£m</b>
Fair value of schemes' assets	394.0	353.7
Present value of defined benefit obligations	(480.6)	(431.6)
<b>Net liability recognised in the balance sheet</b>	<b>(86.6)</b>	<b>(77.9)</b>

## Notes To The Financial Statements (continued)

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

	2013		2012	
	Value £m	Fund %	Value £m	Fund %
Equities	203.5	52	177.5	50
Property	27.1	7	26.8	8
Bonds	131.0	33	117.6	33
Diversified Growth Fund	30.9	8	-	-
Other	1.5	-	31.8	9
	<u>394.0</u>	<u>100.0</u>	<u>353.7</u>	<u>100.0</u>

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)

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 liabilities were

	2013 £m	2012 £m
At 1 April	(77.9)	(68.2)
Income statement	(6.3)	(6.5)
Statement of comprehensive income	(10.4)	(37.5)
Regular contributions	8.0	8.0
Other employer contributions	-	26.3
At 31 March	<u>(86.6)</u>	<u>(77.9)</u>

## Notes To The Financial Statements (continued)

Movements in the fair value of schemes' assets were

	2013	2012
	£m	£m
At 1 April	353.7	307 0
Expected return on schemes' assets	22.3	22 2
Actuarial gains	25.6	3 7
Members' contributions	0.1	0 1
Benefits paid	(15.7)	(13 6)
Company regular contributions	8.0	8 0
Other employer contributions	-	26 3
At 31 March	<u>394.0</u>	<u>353 7</u>

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

	2013	2012
	£m	£m
At 1 April	(431.6)	(375 2)
Service cost	(8.2)	(8 1)
Interest cost	(20.4)	(20 6)
Members' contributions	(0.1)	(0 1)
Benefits paid	15.7	13 6
Actuarial losses	(36.0)	(41 2)
At 31 March	<u>(480.6)</u>	<u>(431 6)</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

The five-year history of experience adjustments is

	2013	2012	2011	2010	2009
	£m	£m	£m	£m	£m
Fair value of schemes' assets	394.0	353 7	307 0	264 3	209 9
Present value of defined benefit obligations	(480.6)	(431 6)	(375 2)	(347 6)	(261 3)
Net liability recognised	(86.6)	(77 9)	(68 2)	(83 3)	(51 4)

Experience gains/(losses) on schemes' assets

Amount (£m)	26.5	2 3	12 4	41 7	(80 7)
Percentage of schemes' assets	6.7%	0 7%	4 0%	15 8%	(38 4)%

Experience losses/(gains) on defined benefit obligations

Amount (£m)	0.1	(3 5)	(9 7)	2 8	18 3
Percentage of defined benefit obligations	0.0%	(0 8)%	(2 6)%	0 8%	7 0%

The last triennial actuarial valuation of the Group's principle defined benefit scheme was at 1 April 2011. The Company made no deficit recovery contributions during the year (2012 £26 3m)

## Notes To The Financial Statements (continued)

The funding levels are monitored on an annual basis, and the Company expects to pay total contributions of around £8m during the year ended 31 March 2014

### 24. Deferred tax liabilities

Deferred tax is provided in full on temporary differences under the liability method using a tax rate of 23% (2012 24%)

The movements on deferred tax were

	2013	2012
	£m	£m
At 1 April	256.2	284.3
Impact of change of corporation tax rate charged to the income statement	(12.3)	(24.2)
Impact of change of corporation tax rate credited to equity	1.7	2.7
Other deferred tax charged to the income statement	(0.9)	8.4
Other deferred tax charged to the income statement - exceptional item	(0.7)	-
Credited to equity	<u>(1.0)</u>	<u>(15.0)</u>
At 31 March	<u>243.0</u>	<u>256.2</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

The deferred tax balance has been reduced by a net credit of £10.6m to recognise the changes in the rate of corporation tax enacted on 17th July 2012 to reduce the rate from 1 April 2013 from 24% to 23%. If the Government proposals contained in the Finance Bill 2013 to reduce the rate of corporation tax by a further 2% for the financial year 2014 and a further 1% for the financial year 2015 onwards had been enacted at the balance sheet date the impact would be a further reduction of approximately £31.0m in total

All deferred tax assets and liabilities are within the same jurisdiction

## Notes To The Financial Statements (continued)

The movement in deferred tax assets and liabilities is shown below

### Deferred Tax liabilities

	Accelerated tax depreciation		Total
	Owned Assets	Leased Assets	
	£m	£m	£m
At 1 April 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
At 31 March 2012	275.9	15.8	291.7
Impact of change of rate	(11.2)	(0.7)	(11.9)
(Credited)/charged to the income statement	(7.0)	0.7	(6.3)
At 31 March 2013	257.7	15.8	273.5

### Deferred Tax assets

	Provisions	Retirement benefit obligations	Other	Total
	£m	£m	£m	£m
At 1 April 2011	(3.9)	(17.8)	(8.4)	(30.1)
(Credited)/charged to the income statement	(0.8)	7.5	0.1	6.8
Charged/(credited) to equity	-	(10.0)	(5.0)	(15.0)
Impact of change in rate	0.4	1.6	0.8	2.8
At 31 March 2012	(4.3)	(18.7)	(12.5)	(35.5)
Charged to the income statement	4.3	0.4	-	4.7
(Credited)/charged to equity	-	(2.5)	1.5	(1.0)
Impact of change in rate	-	0.9	0.4	1.3
At 31 March 2013	-	(19.9)	(10.6)	(30.5)

### Net deferred tax liability:

At 31 March 2012	256.2
At 31 March 2013	243.0

## Notes To The Financial Statements (continued)

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

	2013	2012
	£m	£m
Actuarial losses on defined benefit schemes	(2.5)	(10 0)
Actuarial losses on defined benefit schemes (change of rate)	1.2	2 4
Share-based payments	0.2	-
Share-based payments (change of rate)	0.1	-
Hedging reserve	1.3	(5 0)
Hedging reserve (change in rate)	0.4	0 3
	<u>0.7</u>	<u>(12 3)</u>

### 25. Provisions for liabilities and charges

	2013	2012
	£m	£m
Restructuring		
At 1 April	3.7	2 7
Charged to the income statement	0.5	2 5
Utilised during year	(1.0)	(1 5)
At 31 March	<u>3.2</u>	<u>3 7</u>

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

### 26. Called up share capital

	2013	2012
	£m	£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 (2012 150,950,000) Ordinary shares of £1 each	<u>150.9</u>	<u>150 9</u>

### 27. Employee share schemes

The Pennon Group operates a number of share plans for the benefit of its 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 ordinary shares of 40.7p each under the Sharesave scheme are

## Notes To The Financial Statements (continued)

Date granted and subscription price fully paid		Period when options normally exercisable	Thousands of shares in respect of which options outstanding at 31 March	
			2013	2012
5 July 2005	270p	2008 - 2012	-	24
4 July 2006	358p	2009 - 2013	20	22
3 July 2007	522p	2010 - 2014	5	45
8 July 2008	517p	2011 - 2015	34	39
6 July 2009	386p	2012 - 2016	220	738
28 June 2010	431p	2013 - 2017	282	277
29 June 2011	536p	2014 - 2018	206	222
29 June 2012	588p	2015 - 2017	372	-
			<b>1,139</b>	<b>1,367</b>

The number and weighted average exercise price of Sharesave options are

	2013		2012	
	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	1,367	425	1,410	402
Granted	382	588	226	536
Exercised	(497)	390	(227)	390
Expired	(113)	433	(42)	438
At 31 March	<b>1,139</b>	<b>494</b>	<b>1,367</b>	<b>425</b>

The weighted average price at the date of exercise of Sharesave options during the year was 731p (2012 656p). The options outstanding at 31 March 2013 had a weighted average exercise price of 494p (2012 425p) and a weighted average remaining contractual life of 2.0 years (2012 1.8 years).

The aggregate fair value of options granted during the year was £0.4m (2012 £0.3m), determined using the Black-Scholes valuation model. The significant inputs into the valuation model were

	2013	2012
Weighted average share price	735p	670p
Weighted average exercise price	588p	536p
Expected volatility	19.0%	27.4%
Expected life	3.4 years	3.9 years
Risk-free rate	0.4%	1.4%
Expected dividend yield	4.0%	4.3%

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

## Notes To The Financial Statements (continued)

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

	2013		2012	
	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	404	565	412	549
Granted	109	769	113	698
Vested	(128)	487	(64)	637
Lapsed	(32)	487	(57)	637
At 31 March	353	663	404	565

The awards outstanding at 31 March 2013 had a weighted average exercise price of 663p (2012 565p) and a remaining contractual life of 1.3 years (2012 1.3 years). The aggregate fair value of awards granted during the year was £0.5m (2012 £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

	2013	2012
Weighted average share price	768p	698p
Expected volatility	19.0%	27.4%
Risk-free rate	0.4%	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.

## Notes To The Financial Statements (continued)

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

	2013		2012	
	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	158	589	174	550
Granted	50	755	50	725
Vested	(49)	473	(61)	620
Lapsed	-	-	(5)	620
At 31 March	159	677	158	589

The awards outstanding at 31 March 2013 had a weighted average price of 677p (2012 589p) and a weighted average remaining contractual life of 1.3 years (2012 1.3 years). The Group's share price at the date of the awards ranged from 473p to 755p.

The aggregate fair value of awards granted during the year was £0.3m (2012 £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.

### 28. Retained earnings and other reserves

	Hedging reserve £m	Retained earnings £m	Total £m
At 1 April 2011	(12.8)	354.2	341.4
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 (net of tax)	-	1.1	1.1
<b>At 31 March 2012</b>	<b>(34.3)</b>	<b>377.5</b>	<b>343.2</b>
Profit for the year	-	133.8	133.8
Other comprehensive expense for the year	(7.9)	(11.1)	(19.0)
Other comprehensive income - exceptional item	2.9	-	2.9
Dividends paid	-	(133.0)	(133.0)
Share-based payments (net of tax)	-	1.2	1.2
Pennon shares disposed on vesting of options	-	(0.3)	(0.3)
Pennon shares acquired by the Employee Share Trust in respect of share options granted	-	0.4	0.4
<b>At 31 March 2013</b>	<b>(39.3)</b>	<b>368.5</b>	<b>329.2</b>

## Notes To The Financial Statements (continued)

### 29. Cash flow from operating activities

Reconciliation of profit for the year to cash generated from operations

#### Cash generated from operations

	2013 £m	2012 £m
<b>Continuing operations</b>		
Profit for the year	133.8	129.5
Adjustments for		
Employee share schemes	1.4	1.1
Deferred income released to profits	(0.2)	(0.2)
Profit on disposal of property, plant and equipment	(1.4)	(1.1)
Depreciation charge	102.3	100.5
Interest payable and similar charges	88.9	122.4
Interest receivable	(25.7)	(59.1)
Taxation	30.7	11.9
Exceptional item	(12.5)	-
Changes in working capital		
Increase in inventories	(0.1)	(0.4)
(Increase)/decrease in trade and other receivables	(15.9)	2.7
Increase/(decrease) in trade and other payables	6.4	(13.0)
Decrease/(increase) in retirement benefit obligations	0.2	(26.2)
(Decrease)/increase in provisions for liabilities and charges	(0.5)	1.0
Cash generated from operations	<u>307.4</u>	<u>269.1</u>

### 30. Net borrowings

	2013 £m	2012 £m
Cash and cash deposits	234.4	293.6
<i>Borrowings - current</i>		
Bank overdrafts	-	(15.3)
Other current borrowings	(21.1)	(21.1)
Finance lease obligations	(32.3)	(32.3)
<b>Total current borrowings</b>	<u>(53.4)</u>	<u>(68.7)</u>
<i>Borrowings - non-current</i>		
Other non-current borrowings	(590.2)	(604.1)
Finance lease obligations	(1,191.2)	(1,205.7)
<b>Total non-current borrowings</b>	<u>(1,781.4)</u>	<u>(1,809.8)</u>
<b>Total net borrowings</b>	<u>(1,600.4)</u>	<u>(1,584.9)</u>

## Notes To The Financial Statements (continued)

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

	2013 £m	2012 £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	5.1	5.0
After five years	20.3	19.6
	<u>26.8</u>	<u>26.0</u>

### 32. Contingent liabilities

	2013 £m	2012 £m
Guarantee of borrowings of subsidiary undertaking	<u>371.0</u>	<u>363.9</u>

### 33. Capital commitments

	2013 £m	2012 £m
Contracted but not provided	<u>98.0</u>	<u>51.0</u>

### 34. Related party transactions

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

<u>Parent company</u>	2013 £m	2012 £m
Purchase of goods and services		
-Group expenses	3.5	3.8
Sale of goods and services		
-Administrative services	0.5	0.5
Dividends paid	133.0	77.9
<u>Subsidiaries of the Company</u>	2013 £m	2012 £m
Purchase of goods and services		
-Property consultancy	0.2	0.2
-Billing and collection services	8.8	3.5
Payment for provision of finance		
-Loan interest	16.6	20.1
-Finance lease charges vehicles	0.1	0.1
Sale of goods and services (administrative services)	1.5	0.2

## Notes To The Financial Statements (continued)

<b><u>Fellow subsidiaries of the Pennon Group</u></b>	<b>2013</b>	<b>2012</b>
	<b>£m</b>	<b>£m</b>
Purchase of goods and services		
-Waste disposal	<b>0.5</b>	<b>0.8</b>
-Insurance premia	<b>0.3</b>	<b>0.3</b>
Sale of goods and services		
-Tankered waste and trade effluent charges	<b>0.7</b>	<b>1.0</b>
<b><u>Year end balances</u></b>	<b>2013</b>	<b>2012</b>
	<b>£m</b>	<b>£m</b>
Borrowings		
-Loan from subsidiary	<b>379.8</b>	<b>372.6</b>
-Finance lease balances with subsidiary	<b>0.7</b>	<b>0.7</b>
Receivables		
-Subsidiaries	<b>1.1</b>	<b>0.2</b>
-Fellow subsidiaries	<b>1.2</b>	<b>0.1</b>
Payables		
-Parent company	<b>0.7</b>	<b>5.4</b>
-Subsidiaries	<b>3.2</b>	<b>3.3</b>
-Fellow subsidiaries	<b>-</b>	<b>2.8</b>

### 35. 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, Devon, EX2 7HR.