

SOUTH WEST WATER LIMITED

ANNUAL REPORT AND FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 MARCH 2014

FRIDAY



A34 *A3CEZUKA* #32
18/07/2014
COMPANIES HOUSE

South West Water is a wholly-owned subsidiary of Pennon Group Plc. Since 1989 we have been providing water and wastewater services to households and businesses in Cornwall, Devon and parts of Somerset and Dorset.

To view this report online please visit: southwestwater.co.uk/report2014

South West Water is driven by its 'Pure' vision of 'Pure Water, Pure Service and Pure Environment'. Innovation and sustainable solutions are key aspects of the company's strategy to deliver the water and wastewater services on which lives and businesses in the region depend.

Contents

STRATEGIC REVIEW

CHAIRMAN'S STATEMENT	3
WHAT WE DO	6
CHIEF EXECUTIVE'S STATEMENT	7
OUR PERFORMANCE: WATER	10
OUR PERFORMANCE: SERVICE	13
OUR PERFORMANCE: ENVIRONMENT	17
ENVIRONMENTAL SUSTAINABILITY	20
OUR PERFORMANCE: FINANCE AND ECONOMY	22
ECONOMIC SUSTAINABILITY	27
OUR PERFORMANCE: PEOPLE AND COMMUNITY	29
SOCIAL SUSTAINABILITY	31

GOVERNANCE

CHAIRMAN'S INTRODUCTION	33
BOARD OF DIRECTORS	34
AUDIT COMMITTEE	39
NOMINATION COMMITTEE	45
REMUNERATION COMMITTEE	45
SUSTAINABILITY COMMITTEE	46
DIRECTOR'S REMUNERATION REPORT	49
PRINCIPAL RISKS AND UNCERTAINTIES	69
ANNUAL GENERAL MEETING	77
STATEMENT OF DIRECTORS' RESPONSIBILITIES	79
INDEPENDENT AUDITORS' REPORT	80
FINANCIAL STATEMENTS	82

STRATEGIC REVIEW

South West Water's Annual Report for 2013/14 is designed to provide a fair, balanced and understandable commentary on the company's progress against its objectives over the past year, and provides the information necessary for investors to assess the company's performance, business model and strategy. A range of key performance indicators (KPIs) are used to assess the effectiveness of the company's operational and business activities. These KPIs include both regulated performance measures and those used by the company to monitor performance and drive the achievement of its goals.

CHAIRMAN'S STATEMENT

South West Water's strong operational and financial performance in 2013/14 reflects the investments, hard work and stretching targets set to deliver services that meet our customers' needs and our environmental and legislative responsibilities while ensuring lasting business value.

On behalf of the South West Water Board I am pleased to introduce the South West Water Annual Report 2014.

BUSINESS PERFORMANCE

Over the past year South West Water has continued to deliver strong operational and financial performance. Our investments and activities remain focused on delivering the services our customers depend on in the most cost effective and environmentally responsible way possible. To achieve this we are committed to identifying innovative and sustainable solutions, setting ourselves stretching targets and making prudent, responsible financial decisions that safeguard the value of our business for our shareholder and investors.

Underpinned by increased revenue and good cost control we increased our operating profit and continued to outperform our efficiency targets for the current regulatory period against the backdrop of a drier than average summer and some of the wettest winter weather on record. The company maintained its trend of improved customer satisfaction, celebrated the region's best bathing water quality results in seven years, expanded its capacity for renewable energy generation and secured a seventeenth consecutive year without water restrictions.

Ongoing excellence in our drinking water quality reflected the significant investment made in the maintenance and improvement of our water treatment assets and processes. On the wastewater side of the business, a series of major enhancements were made to our sewer network and assets, particularly those with the potential to impact on the region's coastal communities.

Across the business, the holistic approach we are taking to managing the water and wastewater cycle is helping to deliver increased protection for the natural habitats and ecosystems in which we operate. Work continues to target the root causes of flooding and pollution as we recognise the huge importance of protecting the regional environment and ensuring we can cope with the challenges of climate change and extreme weather.

OUR EMPLOYEES

Through the services we provide, the people we employ, and the third party companies we work alongside, we continue to play a major role in the regional economy. Over the past year the expansion of our apprenticeship programme and the support we have provided for education and training have also helped make a positive impact both on the communities we serve and for the future of our industry. I would like to thank all our employees for their ongoing hard work and dedication.

HEALTH AND SAFETY

We continue to focus on improvements in health and safety. Tragically, while there has been a continued reduction in the number of reportable incidents there was one very sad fatality and our thoughts are with those family, friends and colleagues who have been deeply affected.

DIVIDENDS

The Board is committed to our established dividend policy ensuring sustainable base dividend growth and efficiency outperformance in line with assumptions made by Ofwat in setting prices for the 2010-15 period.

Dividends of £112m were paid in the year, reflecting 74.20p per share.

EFFECTIVE GOVERNANCE

The South West Water Board is dedicated to developing and improving governance structures and activities in line with best practice and the UK Corporate Governance Code. The formation of our Audit, Sustainability, Remuneration and Nomination committees has been designed to further enhance our capacity for internal scrutiny and strategic decision-making.

The recruitment is underway for the appointment of two additional Nonexecutive Directors which will result in a Board composition of four independent Non-executive Directors and four Executive Directors. Before April 2015 I will step down as Chairman and one of the Non-executive Directors will be appointed as Chairman to replace me.

WELL PREPARED FOR THE FUTURE

In December 2013 we published our Business Plan to 2020 (see southwestwater.co.uk/waterfuture). In April 2014 South West Water was the only water and sewerage company (WaSC) to be granted fast-track 'enhanced' status for its business plan.

It was highlighted by the industry regulator Ofwat as 'high quality', achieving enhanced status through strong management with a focus on engagement and balancing the need to keep customers' bills affordable while also investing in the environment and service improvements.

Ofwat noted our robust Board assurance along with our focus on delivering affordability and efficiency through the use of new technology, partnership working and innovative approaches.

The assessment by the regulator is reflective of the strength and focus of the last few years which makes the company one of the highest quality operators in the sector.

MARKET REFORM

The new Water Act became statute on 14 May 2014. As well as setting out a range of reforms for the water sector in England, the Act enables further retail and wholesale competition. Preparations are underway for the retail market opening in April 2017.

South West Water is fully engaged in the 'Open Water' programme which is governed by the Department for Environment, Food and Rural Affairs & Ofwat to shape the implementation of retail market opening in April 2017.

Building on the success of our 'Source for Business' range of specialist advice and support measures, the company has been awarded supply licences covering Scotland, England and Wales, which will allow it to retail water to customers outside the region currently served.

OUTLOOK

South West Water is committed to creating value through the delivery of its 'Pure Water, Pure Service and Pure Environment' strategy while ensuring longterm profitability and sustainability. Moving into the final year of the current regulatory period we do so with confidence in our operational and financial strength.

The dialogue we have had with our customers, stakeholders and regulators in 2013/14 has enabled us to begin moving forwards with a business plan to 2020 that we believe strikes the right balance for the people, economy and environment of the South West.

WHAT WE DO

More than 700,000 households and 70,000 businesses rely on us to deliver safe and clean drinking water and safely dispose of wastewater 24 hours a day, 365 days a year. Meeting their needs, along with our environmental and legislative responsibilities and obligations, is the focus of our operational activity.

INVESTMENTS

South West Water is a wholly-owned subsidiary of Pennon Group Plc., a FTSE 250 business which also owns Viridor, one of the UK's leading recycling, renewable energy and waste management companies.

As a regulated business, our investment programme and the charges our customers receive for the services they use is set every five years in agreement with the water industry's economic regulator Ofwat. We are also subject to quality and environmental regulation by the Drinking Water Inspectorate (DWI), the Environment Agency (EA) and Natural England (NE).

The company strives to deliver the services its customers rely on in the most efficient and sustainable way possible. By targeting the outperformance of our efficiency targets, managing our costs in the most effective way and keeping financing costs as low as possible we generate returns for our investors and shareholders, in addition to those earned through our asset base.

NON-REGULATED BUSINESS

In addition to our regulated services we also invest in a number of non-regulated business areas. These include:

- renewable energy (including our wind turbine and solar PV installations)
- Source for Searches (a comprehensive range of residential and commercial property services to support the purchase, sale, re-mortgage or development of property or land)
- laboratory Services (analytical services including water, wastewater, soil and sludge analysis)
- training (training programmes for various business areas including operational skills such as driver training, health and safety, clerical skills and energy efficiency).

SOURCE FOR BUSINESS

Source for Business offers a range of additional commercial services for non-household customers including water efficiency advice and support.

SOUTH WEST LAKES TRUST

The South West Lakes Trust (SWLT) manages the access and recreational opportunities available at our reservoir sites.

OUR BUSINESS MODEL

The South West Water business model is designed to ensure long-term operational and financial success for the benefit of shareholders, customers and the environment.

The past twelve months have seen significant progress in demonstrating robust operational and financial performance aligned with our long-term vision of reliable, responsive and resilient services delivered in the most efficient and sustainable way possible.

CHIEF EXECUTIVE'S STATEMENT

We know from talking to our customers that their number one priority remains the provision of a clean, safe and reliable supply of drinking water.

South West Water continued to perform well in 2013/14 in delivering this priority with our results for water quality, leakage and water supply interruptions remaining on target. The number of contacts about discolouration saw a slight increase on the previous year, largely due to weather-related incidents involving burst water mains. Targeted investment in tackling aesthetic issues such as discoloration is being carried out this year and next through water mains rehabilitation and advanced water treatment technologies.

The year itself began with a stark reminder of the need to continue to invest to mitigate the impact of extreme weather on our region's infrastructure. In early April, unusually high winds and pounding seas resulted in the collapse of a sea-wall in Torbay, Devon. This exposed a strategically vital sewer main and prompted a major emergency response from South West Water, its contractors and the local council.

The importance of protecting our customers' water and wastewater services from such extreme events was a key consideration of our Business Plan to 2020. Published in December 2013, it followed two years of intensive research, our largest ever consultation with customers, and the challenge and scrutiny of the independent WaterFuture Customer Panel.

In March 2014 the Business Plan was the only water and sewerage company plan to be given 'enhanced' status and subsequently fast-tracked by Ofwat, the water industry regulator. The plan included six Board pledges:

- Keep price rises below inflation
- Deliver efficiency through innovation to keep costs and customers' bills as low as possible
- Share the benefits of success fairly between customers and investors
- Make significant improvements to frontline customer service
- Deliver service and environmental improvements
- Support sustainable regional growth.

In 2013/14 South West Water also published its Water Resources Management Plan. This highlighted our strong water resources position as the legacy of two decades of investment in reservoirs, pipelines, pumping schemes and leakage reduction. We are confident in our forecast of a net surplus of water until at least 2040, a major reassurance for households and businesses for which an available and sufficient water supply is vital.

Work continues to increase the standard of our wastewater treatment processes and systems as we recognise the implications for the sensitive natural environment and economy of our region. A major programme of investment is currently underway in order to improve the reliability of our wastewater treatment works and this contributed to our best ever results in 2012/13.

Similarly, we continue to invest in protecting bathing and shellfish waters and were pleased to announce our best bathing water quality results in seven years. The 2013 summer was the warmest in the UK since 2006 with the relatively dry conditions placing less pressure on our assets and networks than the previous wetter year. 99.3% of bathing waters in the region met or exceeded the minimum European water quality standard. In 2014/15 £18m is being invested to ensure we retain such high quality results when new standards come into force under the Revised European Bathing Waters Directive in 2015.

While it is unfortunate that our wastewater compliance saw a slight decline in 2013/14 we are already taking steps to target those works most in need of improvement.

After a relatively dry summer, the 2013/14 winter was anything but. In January 2014 England experienced some of the wettest weather in 250 years. This resulted in serious flooding across parts of the South West although the number of sewer floodings was substantially fewer than the previous year (which was classified as a once in 100-year wet weather event).

Alongside other key regional agencies and organisations, South West Water continues to take a lead in regional flood management. In support of the 2015-20 Business Plan we are pioneering the use of sustainable drainage schemes alongside a raft of cost-effective measures designed to reduce the impact of wet weather on our sewer network and assets. Known as 'Downstream Thinking', a series of pilot schemes are set to be rolled out later this year.

The sustainability of our business, the communities we serve, the environment and region in which we live and the economy within which we work, is critical. Entwined with our business strategy is our holistic approach to the water and wastewater cycle. At each stage of that cycle we are focused on the identification and implementation of best working practice.

A key example is our 'Upstream Thinking' catchment management programme which has been working since 2009 to improve natural water quality and water storage in the landscape using low impact sustainable measures such as the re-wetting of moorland peat bogs and partnership working with farmers to reduce the impact of agricultural run-off. In 2013/14 we were delighted that Upstream Thinking won yet another prestigious national award – the Living Wetlands Award from The Chartered Institution of Water and Environment Management (CIWEM).

Following the introduction of a new Customer Relationship Management (CRM) system in 2012/13 our customer service score continued to increase in 2013/14 with the number of written complaints now tracking at levels half that of five years ago. The increased use of online communications (including MyAccount online) is also helping to improve the customer experience and we are making targeted investment to further improve our customer satisfaction rate. An exponential rise in traffic to our mobile phone app and the online payment service during early 2014 has indicated that more and more customers are choosing to interact with us digitally. As such, it is our intention to continue to expand the scope, quality and range of services offered in this way.

Affordability continues to be a key concern for our customers. In order to help those most in need we became one of the first companies to offer a social tariff in 2013/14. Furthermore, as part of our Business Plan to 2020 we announced a price freeze for 2014/15 – a move that was widely welcomed by customers, stakeholders and regional media. We also successfully managed the implementation of the £50 Government payment (see page 14).

For our business customers we continue to improve our core services while expanding the supplementary services offered by 'Source for Business'. Ahead of the retail market opening in 2017 we are fully engaged with the OpenWater programme and are assessing the opportunities that this will present.

2013/14 was a milestone year for our energy strategy. We continued to invest in renewable energy generation, bringing the total number of operational sites using solar schemes to over 30 with solar panels also installed at the company headquarters in Exeter, Devon. Together with energy efficiency measures, our renewable energy schemes (including hydro generation, combined heat and power (CHP) and our wind turbine at Lowermoor Water Treatment Works) are designed to help offset the large energy costs of operational activities such as drinking water and wastewater pumping.

Across the company there were many successes and noteworthy developments in 2013/14 which bode well for the future success of the company. The expansion of our apprenticeship programme has now placed 43 young people across the company and South West Water has also been instrumental in its support for the creation of a new University Technical College (UTC) for the region. In each case it is our ambition to nurture fresh talent and skills for the future thereby giving a valuable boost to the regional economy in what remains a troubled economic climate.

Central to all our past and present operational successes are the efforts and ingenuity of our staff. Their health and safety is our primary concern and with that in mind everyone in South West Water was shocked and saddened to learn of the death of a member of our wastewater team at Falmouth Waste Water Treatment Works, Cornwall, in December 2013. An investigation is currently underway and all my sympathies are with his family, friends and colleagues.

OUR PERFORMANCE: WATER

Our aim is to provide an uninterrupted supply of fresh clean drinking water that not only meets the highest official drinking water quality standards but is also free from any unwanted taste, smell or colour.

To achieve this we continue to invest in our assets and operations while pioneering new technologies and innovative sustainable solutions in areas such as catchment management.

DRINKING WATER QUALITY

In 2013/14, despite the challenges of a dry summer with high levels of demand followed by an intensely wet winter, South West Water continued to deliver outstanding water quality with an official result* of 99.98% – within the top three of all UK water and sewerage companies.

The excellent quality of our drinking water reflects the legacy of investment made in water mains rehabilitation, the maintenance and improvement of our treatment works and processes and the efforts and expertise of our operational staff. Work also continues to improve the aesthetic qualities of our water (taste, odour and colour) as we recognise the importance of this to our customers.

During the year we did have to issue three boil water notices which affected around 3,000 customers in total. We also had issues with discolouration at Tamar Lakes Water Treatment Works, Cornwall, in August 2013. In each case, South West Water took quick and decisive action to identify and address the respective issues while communicating proactively with the customers affected.

In the past year we have commenced significant enhancements to the treatment processes at Restormel and Wendron water treatment works which supply around half of the drinking water in Cornwall. Additional filtration is being put in place in order to increase protection from chemicals and other contaminants in the raw water supply (e.g. from agricultural run-off) and ensure we can meet increasing standards for water quality.

WATER RESOURCES

The availability of water is essential to homes and businesses and South West Water is proud to have avoided water restrictions for a 17th consecutive year.

In summer 2013 a period of very dry weather coincided with the peak tourist season placing the highest level of demand on our resources for several years.

Together with our prior investment in reservoirs and the supply network (including Park and Stannon lakes, the former China Clay pits acquired in 2011), South West Water's careful resource management ensured that unrestricted supplies were available throughout this period.

Following the wettest UK winter on record our reservoirs reached near 100% capacity.

South West Water's final Water Resources Management Plan (southwestwater.co.uk/waterresourcesplan), published in June 2014, sets out how we intend to maintain a balance between the supply and demand for water over the next 25 years.

LEAKAGE CONTROL

South West Water has met its leakage target every year since they were introduced. 2013/14 was no exception and we remained in line with our target of 84Ml lost on average per day. Using advanced diagnostic tools to provide alerts to unusual fluctuations in water use, our leakage detection teams are now targeting a faster response to any leaks and bursts.

This is supported by the work undertaken in recent years to increase our use of remote communication technologies and expand our pressure management capabilities in order to reduce the risk of failures on the network.

Furthermore, South West Water is now taking a zero tolerance approach to water theft. Increased prosecutions are intended to dissuade individuals from taking water from the network illegally as this not only affects our leakage rate but is also potentially damaging to our drinking water assets, network, and drinking water quality.

PREVENTING INTERRUPTIONS

Recognising the impact they can have on our customers' livelihoods and businesses, we continue to take steps to minimise the risk of water supply interruptions and to ensure that any issues on the network are quickly resolved.

Maintenance work, the actions of third parties (e.g. construction) and events beyond our control (such as extreme weather) can potentially cause interruptions to water supplies.

In recent years we have carried out significant investment in mains rehabilitation and resilience, alongside measures to limit the direct effect of interruptions on our customers (e.g. using temporary hoses or tankered water to provide an alternative supply).

In 2013/14 the average duration of a supply interruption per property was fifteen minutes (0.25 hours). This represents an improvement on the previous year and is less than a third of the average duration experienced at the start of K5 (2010-15).

UPSTREAM THINKING

South West Water's flagship programme of catchment management continues to deliver improvements to targeted areas of moorland and agricultural land in order to improve natural water quality and water storage in the landscape.

Additional benefits include carbon capture, enhanced biodiversity and reduced flood risk through stemming the flow of water off the land.

There are two main strands to the project:

- moorland restoration (including the re-wetting of peat bogs using low-impact sustainable techniques such as ditch blocking)
- agricultural improvements (including advice, support and access to funding for reducing the impact of farm activity on water courses through land and habitat management).

Between 2010 and 2015 we are working alongside partner agencies and organisations including Natural England, wildlife trusts, and the region's national park authorities to target the restoration of 4,942 acres and 650 farm schemes.

In January 2014 a team of researchers at the University of Exeter confirmed that the Exmoor Mires Project (one of the schemes under the 'Upstream Thinking' programme) had, over the course of three years, reduced the amount of rainwater leaving the moorland by up to a third in the areas completed. The study also confirmed tangible improvements in water quality.

OUTLOOK

Recognising that a 'clean, safe and reliable supply of drinking water' is our customers' number one priority we continue to target high standards of drinking water service provision while also looking at how we can make our drinking water operations more efficient and environmentally benign.

Our Business Plan to 2020 highlights some of the investments we plan to make in K6 (2015-20) in support of the following key 'outcome' areas:

CLEAN, SAFE AND RELIABLE SUPPLY OF DRINKING WATER

Investment in our assets and treatment processes will be aimed at maintaining and improving drinking water quality, tackling aesthetic issues (taste, odour, discolouration), and further reducing interruptions. Our drinking water strategy includes plans for a new water treatment works in North Plymouth which uses cutting edge water treatment technologies to improve efficiency. A pilot scheme is currently in place and the preliminary results have so far been extremely positive.

AVAILABLE AND SUFFICIENT WATER RESOURCES

Given our healthy water resource position, investment in this area is designed to maintain the current supply/ demand surplus. Longer term we are also aiming to improve our capacity to move water to where it is needed most through the duplication of some sections of network.

Fundamental to our strategy is the ongoing maintenance of our drinking water assets and networks alongside the work we are doing to pioneer advances in drinking water treatment technology and catchment management. Investment in infrastructure is also complemented by identifying and implementing improved communication technologies in order to manage our workforce and operations in an increasingly efficient and customer-focused way.

OUR PERFORMANCE: SERVICE

Our goal is to provide our household and non-household customers with the highest standards of service, ensuring that their requests, problems and queries are dealt with first time and that the service they receive represents value for money.

In recent years we have taken steps to ensure that they can contact us in a variety of ways and that they can access the right type and level of advice and support depending on their needs and circumstances.

CUSTOMER SATISFACTION

Since the start of K5 (2010-15) we have almost doubled our customer service score through investment in our frontline customer services alongside operational improvements. In that same time period the number of written complaints and the number of unwanted phone contacts have each been halved.

We know from talking to customers that if they do need to get in touch with us they value speaking to a person with their query or issue resolved first time. In the past year we have moved away from a semi-automated system to ensure that all calls are answered by an operator at our regionally-based call centre who then directs the call to an appropriate team. This has reduced the number of abandoned calls by over 40%.

Whilst these improvements are significant there is still work to be done to improve customer satisfaction levels and reduce the number of written complaints.

Having carried out our largest ever process of customer research and engagement in support of the Business Plan to 2020 (see page 32) we now have an even greater understanding of our customers' needs and preferences. Part of our strategy to improve customer satisfaction is to expand the range, scope and quality of our customer communications and ensure that we contact them at the right time and in the right way.

By being more proactive in the way we disseminate information and advice, in particular by making the most of digital communications and new media, we can improve our customers' overall experience and perception of the company. This includes using our knowledge of the factors that can contribute to operational failings (such as seasonality and weather conditions) to better predict when we should be issuing outbound communications to those potentially affected.

In support of the business plan we are already targeting a range of improvements across the business in order to improve customer satisfaction, both household and non-household. This includes further staff training and investment in outbound technologies to ensure quicker and more integrated responses to any issues our customers may have.

Our business and other non-household customers will also benefit from the improved services offered under 'Source for Business'.

AFFORDABILITY

According to EU data Cornwall is the UK's poorest region¹. For many people across the wider South West Water region, the struggle to make ends meet is exacerbated by lower than average incomes, relatively high house prices and high energy costs.

Water and wastewater charges are also higher than the national average, largely due to the scale of investment necessary to safeguard the region's sensitive – and economically vital – natural environment.

¹ Eurostat <http://epp.eurostat.ec.europa.eu>

To provide help for those who genuinely struggle to pay and reduce water debt South West Water has implemented a number of schemes. These include:

- **WaterCare+** – which has now helped more than 12,000 customers through a benefits and entitlement and tariff check, water audit and water efficiency measures
- **ReStart** – which helps customers reduce their debt through the incentivisation of regular payments
- **WaterSure** – for those in receipt of means-tested benefit or tax credit
- **Freshstart Fund** – operated in conjunction with the Citizens Advice Bureau for one-off hardship cases.

During 2013 we were among the first of the UK water companies to launch a social tariff. Means-tested for those on very low incomes, the WaterCare tariff has so far enabled more than 1,000 customers to pay their bills by reducing their standard metered charges. We are also working with a number of local social housing providers to provide targeted practical and financial assistance to low-income tenants who struggle to pay their bills.

Furthermore, and to coincide with the publication of our Business Plan to 2020 in December 2013, we announced a pledge to freeze bills for 2014/15. The move was in direct response to the research findings supporting the business plan which highlighted the cost of water bills as a key concern for the majority of our customers.

GOVERNMENT PAYMENT

In 2011 the Government announced its recognition of the high charges issue in the South West region, together with plans for an annual household bill reduction. This followed lobbying from ourselves, the region's MPs, media and customer groups.

The £50 Government Payment came into effect in April 2013. As the annual payment passes directly to eligible customers it has no impact on our finances. South West Water successfully managed the implementation of the payment which has been welcomed by our customers.

The payment is due to continue until at least 2020.

METERING

The vast majority of our customers feel that metering is the fairest way of charging. In the past year we have installed 10,100 standard meters and 78% of household customers are now metered.

The number of new meter installations was slightly fewer in 2013/14 compared with 2012/13. This reflects the already high level of metering penetration in our region.

In the long term it is our ambition to ensure that meters are installed at every customer property where it is practical to do so. As such, we continue to promote and support the free installation of standard meters on request for those wishing to make the switch.

PRIORITY SERVICES

We are committed to helping our customers, especially those who require additional assistance due to disability, age or illness. Some of the priority services we offer include:

- alternative bill formats (large print or braille, telephone bill reading, sending bills to a helper or carer)
- meter reading and meter relocation (depending on circumstances)
- support during supply interruptions (e.g. providing an alternative water supply)
- information and advice on water fittings for those with disabilities.

We also ensure that the facilities at many of our recreational sites are designed to be accessible to everyone. As at 31 March 2014 there were 9,282 customers on our priority services register.

OUTLOOK (HOUSEHOLD)

Improving the services and experience that our customers receive when interacting with us requires both improvement at operational level and in the way in which we communicate and respond to any issues, queries or requests for information.

It is vital that our services represent value for money and that they are perceived in that way. Ultimately, our goal is to achieve industry-leading customer satisfaction levels, ensuring bills are kept as low as possible and minimising the likelihood that a customer will need to contact us with an issue or complaint.

Our Business Plan to 2020 highlights some of the investments we plan to make in K6 (2015-20) in support of the following key 'outcome' areas:

RESPONSIVE TO CUSTOMERS

We will continue to review and enhance our customer relationship management systems, adapting to new and emerging trends such as the growth in digital media.

FAIR CHARGING

Our business plan included a Board pledge to keep 2015-20 price rises below forecast inflation and we are also freezing charges for 2014/15. We intend to continue developing and promoting our affordability initiatives, offering support and assistance to those who genuinely struggle to pay.

RESILIENCE IN EXTREME CONDITIONS

Making sure the water and wastewater services we provide can withstand the potential impacts of extreme weather and security threats.

BUSINESS CUSTOMERS

Through Source for Business, its business to business service brand, South West Water provides water and wastewater services to 73,000 businesses and other non-household customers (e.g. schools, hospitals). Many of them are small to medium sized enterprises with the tourism and agriculture sectors accounting for 45% of non-household water use.

Our mission is to ensure all our customers receive excellent service, expert advice, and innovative solutions to water management. We do this through providing dedicated contact routes to business customer specialists; account managers for larger organisations; water efficiency advice and support; laboratory, analytical and billing services; and a range of innovative products and services to improve water use and wastewater management.

In the past year South West Water has continued to grow its relationships with non-household customers and expand the range of services available. This includes preparations to introduce sector specific Business Solutions Managers that understand our customers' businesses as well as our own.

OUTLOOK

From 2017 onwards non-household customers will be able to choose their water and wastewater service provider. During 2015-20 we are planning to offer non-household customers a series of new tariff options alongside our regulated default tariff.

We will offer a suite of services to support their business growth – from looking at innovative solutions to help reduce their water bills, account management and usage analysis, to contingency planning and support.

Furthermore, we continue to work closely with the Open Water Programme which has been established to facilitate the implementation of market reform in the water sector. South West Water is currently preparing for the changes and has gained its water supply licences for both England & Wales and Scotland.

By 2017, we want customers to view Source for Business as the retailer of choice

OUR PERFORMANCE: ENVIRONMENT

Our business depends on the health of the natural ecosystems in which we operate. As environmental stewards, we have a duty to ensure our activities not only have a minimal impact but also enhance the environment where possible.

A focus on low-impact sustainable schemes and investment in renewable technologies are key aspects of our strategy for environmental protection.

BATHING WATER QUALITY

In 2013 the region's bathing water quality reached the highest standard in seven years. Out of the 145 designated bathing waters sampled, only one failed to meet the minimum European water quality standard while 132 (91%) met the tighter guideline standard.

In order to further protect bathing compliance, we supported local beach managers in issuing six abnormal situation notices to enable prospective beach users to make an informed decision on bathing.

South West Water recognises the major benefits that high quality bathing water brings to the region, both in terms of attracting visitors and enhancing the quality of life for those that live here. High quality coastal waters also support the marine ecosystems which are invaluable to industries such as fishing and shellfisheries.

We have begun a programme to spend £18m on a range of schemes to improve bathing water quality further. The locations being targeted include Lyme Regis, Teignmouth, Torbay, Mothecombe, Seaton (Cornwall), Looe and Combe Martin. This investment is being made in preparation for the more stringent standards of the European Union's revised Bathing Water Directive, which comes into force in 2015.

Furthermore, as part of our Business Plan to 2020, we plan to invest an additional £42m². We are working alongside partner organisations such as local councils and tourism authorities to look at how to address the variety of factors that potentially affect water quality and the environment (e.g. agricultural run-off, misconceptions, impurities from birds and animals).

WASTEWATER TREATMENT STANDARDS

Two years ago, South West Water agreed a glidepath with the Environment Agency for improvement work targeting those wastewater treatment assets most at risk of failure.

This major investment, which has so far targeted more than one hundred sites, was reflected in our best ever compliance during 2012 for both Population Equivalent Sanitary Compliance (the percentage of the population served by works that meet official criteria) and Numeric Compliance (which gives equal weighting to small and large treatment works).

In 2013, issues with two of the sites earmarked for improvement, in particular Marsh Mills Wastewater Treatment Works in Plymouth which serves a large population centre, had a temporarily detrimental effect on the Population Equivalent Sanitary Compliance score.

Substantial investment continues to bring those sites at risk of failure in line with targets and address any outstanding issues. The first months of 2014 have already seen progress in this regard. Furthermore, South West Water recognises the implications of the revised Bathing Water Directive for wastewater treatment requirements. This comes into force in 2015 and a strategy is in place to deliver the necessary maintenance and improvement work.

² 2012/13 price base

FLOODING

Recognising the potentially devastating impact of flooding on lives and businesses, South West Water continues to invest in measures and activities to minimise the likelihood and effects of such events.

After the extremely wet weather of the previous year, 2013/14 saw an overall reduction in floodings despite above average rainfall and a spate of severe storms and high seas causing disruption and damage to infrastructure during winter 2013/14.

The number of floodings caused by hydraulic overload (sewers becoming overwhelmed by the sheer volume of water) was 50 - significantly fewer than the previous year although above the average for the 2010-15 period. The number of floodings resulting from other causes (e.g. blockages, sewer collapses) remained below the 2010-15 average although more work is required in order to reduce this number further.

The issue of flooding came under the national spotlight in early 2014, largely due to the severe flooding that took place in neighbouring Somerset, which necessitated the evacuation of several communities. Amid calls for government action on the issue was a focus on the need for holistic approaches to flood management.

In recent years, South West Water has spearheaded partnership-focused initiatives that take into account the wide range of factors that can cause and exacerbate flooding events.

Working alongside lead local flood authorities, other partner agencies, developers and environmental groups, we are identifying best practice in the management of extreme rainfall, flooding and sewer misconnections.

This spans everything from our catchment management programme under Upstream Thinking (page 11), through to our investment in flood defence schemes, and, more recently, our new programme of work known as 'Downstream Thinking'.

POLLUTION PREVENTION

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.

Compared with the previous year, 2013 saw a rise in the total number of pollution incidents and the number of significant (Category 2) pollution incidents. Again, there were no major (Category 1) pollutions.

While this year's performance was disappointing, it should be seen in the context of changes in the scope of reporting and the steps South West Water has taken to increase its capacity to identify and 'self-report' pollution incidents when they occur.

Of the ten significant incidents (Category 2), six related to cases in which amenities (e.g. beaches) were closed as precautionary measures. Prior to 2013, such instances were not always categorised in this way.

DOWNSTREAM THINKING

Taking a lead from our award-winning 'Upstream Thinking' initiative (see page 11) 'Downstream Thinking' is South West Water's catchment-based approach to alleviating sewer flooding and reducing the likelihood of watercourse pollution through ecologically sensitive 'soft' engineering schemes.

Spearheaded by South West Water and set to be delivered in partnership with a range of stakeholder groups including the Environment Agency, local councils, Highways Agency and lead local flood

authorities, 'Downstream Thinking' incorporates a range of activities including Sustainable Drainage Systems (SuDS), habitat management and the targeting of misconnections.

South West Water is set to roll out the first pilot scheme in the 2014/15 financial year. During 2013/14 preparatory work for this scheme - which will focus on drainage issues in Truro, Cornwall, - included site investigations and planning activity.

ENERGY & CARBON

Vital to the long-term sustainability of both our business and the environment are the steps we take to minimise our energy consumption and carbon footprint.

Since the start of the current investment period (2010-15) we have improved the way we manage energy and emission levels through a combination of the following:

- asset optimisation and the refurbishment of pumping equipment
- new technologies (e.g. operating equipment and systems remotely under our PUROS scheme)
- promotion of energy efficiency through our in-house Powerdown initiative (which encourages staff to use less power at work and at home e.g. fuel and transport efficiency)
- renewable energy generation.

In 2013/14 we successfully met our greenhouse gas emissions target. Emissions were kept at a level lower than that of our baseline position at the start of the current investment period. Annual emissions from regulated and non-regulated business activities in 2013/14 were 157.4 ktCO₂e (2012/13: 162.2ktCO₂e (rebased in line with revised emission factors).

We continued our investment in renewable energy technologies, commissioning 490kW of new capacity within 2013/14 including our largest solar PV installation to date (219kW at our Exeter headquarters). This takes our overall renewable capacity to the 10MW mark enabling us to generate around 25GWh of clean energy per year. Overall energy use for the year was 264.5GWh (2012/13: 266.9GWh).

OUTLOOK

South West Water continues to make major investments in environmental protection, not least through targeted improvements associated with improved bathing and shellfish water quality. In 2014/15 we are spending £18m on a range of schemes to further improve bathing water quality at Lyme Regis, Teignmouth, Torbay, Mothecombe, Seaton (Cornwall), Looe and Combe Martin.

Our Business Plan to 2020 highlights some of the investments we plan to make in K6 (2015-20) in support of the following key 'outcome' areas:

PROTECTING THE ENVIRONMENT

This includes investment to reduce the likelihood of pollution, improve our wastewater processes to meet all emerging environmental regulations and reduce our carbon footprint.

RELIABLE WASTEWATER SERVICE

It is our aim to reduce internal sewer floodings, collapses and blockages while also tackling odour issues at our operational sites.

BENEFITING THE COMMUNITY

Recognising the economic importance of bathing and shellfish waters to our local economy this includes increased protection for these coastal and estuarine areas and our region's rivers through investment in wastewater treatment assets and our monitoring and control technologies.

Our strategies are designed to ensure we meet or exceed environmental regulations and legislation as it develops. Furthermore, we remain focused on pioneering new and improved ways of working that reduce our environmental impact.

The Water Act sets out a range of reforms for the water sector in England and proposes to increase both retail and wholesale competition. Preparations for market reform are underway with the retail market opening expected from April 2017. The impact of long-term competition within upstream activities is also being considered.

ENVIRONMENTAL SUSTAINABILITY

MANAGING THE LANDSCAPE

In recent years South West Water has pioneered a holistic approach to the management of water and wastewater. Rather than focusing solely on our own assets and operations this looks at the water cycle in the wider landscape, the many different factors that influence it, and how we can work in collaboration with other key regional and environmental stakeholder groups to develop cost-effective sustainable solutions for issues ranging from water pollution to flooding.

The work we have carried out as part of Upstream Thinking is recognised globally as an exemplar of catchment management best practice. It is our hope to replicate this level of success and recognition with our new 'Downstream Thinking' initiative. This is designed to address urban drainage issues in a similar ecologically sensitive and partnership-driven way.

Managing the landscape sustainably brings multiple benefits. In addition to improving the quality of natural resources and helping to minimise the effect of our operations it also has positive knock-on effects on aspects such as biodiversity. Studies of the peat bog restoration work carried out as part of Upstream Thinking have shown significant increases in flora and fauna, including the proliferation of a number of rare species of birds and insects.

During 2013/14 we retained our ISO 14001 certification for our environmental management system.

ENHANCING AND PROTECTING THE ENVIRONMENT

From the way in which we abstract raw water at its source through to the systems and processes involved in returning wastewater to the environment, South West Water aims to limit any negative effects of our operational activity and, where possible, have a positive environmental impact. The major investment we have made over the past two decades has radically improved the quality of our river and bathing waters. Indeed, in the past year we have celebrated our best bathing water quality results in seven years (see page 17) and we continue to work towards higher standards in areas such as wastewater treatment.

Our strategy is to continue to invest in the maintenance and improvement of our infrastructure, managing our operational sites responsibly while identifying and spearheading sustainable solutions that are sensitive to our natural surroundings, practicable and cost-efficient. This includes tackling issues such as sewer flooding through our new Downstream Thinking programme (see page 18).

Among our environmental priorities is a reduction in the number of pollution incidents. In 2013/14 while we avoided any Category 1 (major) incidents we did not meet our sustainability target for fewer than seven Category 1 and Category 2 (significant) incidents combined. Changes in the scope of reporting and increased monitoring accounts for this to some extent (see page 18), however this is a disappointing result and further work is clearly needed in order to move us closer towards our long-term aim of zero harmful pollutions.

The environmental impact that occurs as a result of our energy use is also a point of focus. In 2013/14 we increased our capacity for renewable energy and continued to invest in the optimisation of our assets, systems and working practices in order to make them more energy efficient. Compared with our 2009/10 baseline our carbon emissions were successfully reduced and our energy consumption was lower than the previous year (see page 19).

MAKING USE OF WASTE PRODUCTS

Our operational activities inevitably produce a range of waste products, many of which have the potential to be recycled.

At present we recycle all of our sludge using anaerobic digestion and lime stabilisation techniques to create a biosolid product for agricultural use. We have also invested in creating energy from waste and currently have seven operational CHP (Combined Heat and Power) plants. Part of our long-term strategy is to further develop each of these activities.

We are currently working with our supply chain partners to minimise the amount of waste on construction sites and make use of by-product materials such as rock, grit, plastics and other materials. In the past year this has included the recycling of excavated concrete at Radford Wastewater Treatment Works in Plymouth and the use of recycled plastics at Ashford Wastewater Treatment Works, North Devon.

Furthermore, we continue to take steps to reduce the amount of waste sent to landfill through the recycling and composting of grit and screenings (solid materials extracted in the early stage of wastewater treatment). In particular we are using grit in our land restoration activities, such as those at Park and Stannon lakes.

OUR PERFORMANCE: FINANCE AND ECONOMY

Strong financial policies and prudent investment decisions are critical to ensuring a successful future for our business and the major role we play in the regional economy.

As a result of increased revenue and an ongoing strength in operational cost control, South West Water's operating profit increased in 2013/14 by £11.9m to £226.7m.

Revenue grew by 4.3% to £521.5m as a result of tariff increases, new connections and other sales, partly offset by an overall reduction in demand and the effect of customers switching to a metered tariff.

Approved tariff increases, including the 1.3% K factor, amounted to £24.8m, with an additional £3.7m generated by c.6,000 new customer connections. Customer demand has fallen with a reduction of -1.0% on last year, a lower reduction than previous years reflecting the dry summer in 2013.

Over 78% of South West Water's domestic customers are now benefitting from a metered supply, with an additional 10,070 customers opting for a meter in 2013/14 (2013: 12,600).

OPERATING COSTS

Our operating costs, including depreciation, rose by £9.5m (3.3%) to £294.8m, below the allowed price rise of 4.3%. The key movements were:

- cost increases (including, power, business rates and pension costs)
- increased depreciation and costs of capital schemes
- increased cost of sales from increased developer services and other sales activity
- additional efficiencies delivered in the year. Cumulative K5 efficiency to date is 14% ahead of target as a result of early delivery
- other cost movements.

Cumulative cost increases over the K5 period to date remain lower than average RPI for the same period.

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 (2012/13: £0.5m).

Whilst the bad debt charge is in line with last year the increase in revenue reduced the proportion as a percentage of revenue to 1.8%. Debts totalling £7.9m (2012/13: £9.1m) were written off against the provision during 2013/14, of which £1.8m relates to personal and commercial bankruptcy, and £1.1m related to our ReStart programme, a South West Water customer affordability initiative.

NET FINANCE COSTS

Net finance costs has reduced from the prior year at £64.5m (2012/13 restated: £68.2m before exceptional items), predominantly reflecting the lower interest on RPI index-linked bonds and lease.

South West Water has access to overall interest rates that are amongst the lowest in the water industry. Interest cover for 2013/14 is both within the required levels for financial covenants and in line with expectations.

PROFIT BEFORE TAX

Profit before tax was £162.2m, an increase of £15.6m (excluding net exceptional income) from the prior year (£3.1m increase, including net exceptional income in 2012/13).

TAXATION

The current tax charge for 2013/14 of £28.6m (2012/13: £44.6m) included £3.0m credit of adjustments for prior year. A deferred tax credit of £29.9m resulted in a net total tax position of a credit of £1.3m (2012/13: charge £29.5m).

The current corporation tax charge which is included within the tax charge, decreased by £16.0m on 2012/13. This reflects the increase in profit reported, offset by the decrease in corporation tax rates to 23% and adjustments to the tax charge in respect of prior periods.

Deferred tax for the year was a credit of £29.9m (2012/13: credit £15.1m). The increased deferred tax credit was driven by the impact of the reduction in the rate of corporation tax for future years, and adjustments to the tax charge in respect of prior periods.

This will continue to change in line with corporation tax rates. The company will apply relevant tax laws in a reasonable way and only engage in tax planning when it is aligned with the commercial and economic activity of the business.

DIVIDENDS AND RETAINED EARNINGS

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.

Dividends of £112.0m were paid to the parent undertaking (2012/13: £133.0m), representing a base dividend of £65.0m, £17.0m of outperformance dividend based on cumulative performance to 31 March 2014 and £30.0m taking into consideration the balance sheet position and key financial ratios of South West Water.

The dividend was calculated with reference to the projections in the Ofwat 2009 Final Determination.

CAPITAL INVESTMENT

Capital additions for the year were £141.6m, an increase from £116.5m in 2012/13.

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 in water quality with treatment upgrades at two key sites including Restormel which provides approximately half of the drinking water for Cornwall
- investments in assets to improve bathing water quality to meet revised European Guidelines in 2015
- delivering additional capacity to meet growth requirements – including supply to two new towns within the region
- focusing on compliance at wastewater sites during periods of extreme weather
- safeguarding water resources – upgrades to four reservoirs across the region
- innovative investments to reduce flooding for those customers previously highlighted as at risk.

South West Water continues to deliver capital projects in line with Ofwat, Drinking Water Inspectorate and Environment Agency expectations. Performance cumulatively to date is in line with target for K5.

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.

LIQUIDITY AND DEBT PROFILE

The company has a strong liquidity and funding position with £315.8m cash and deposits at 31 March 2014 (including £164.2m of restricted funds representing deposits with lessors against lease obligations). In addition to £275m of undrawn facilities, total of £80m in new and renewed debt facilities were arranged during the year.

The company's financing structure gives scope and flexibility needed to implement our strategic objectives and maximise value.

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.

At 31 March 2014 the company's loans and finance lease obligations totalled £1,961.5m. After the £315.8m held in cash this gives a net debt figure of £1,645.7m. An increase of £45.3m during the year.

The company's debt has a maturity of up to 43 years with an average maturity of 25 years. The company has fixed, or put swaps in place to fix the interest rate on at least 50% of its debt for the entire K5 period at an average interest rate of 3.8%. The balance sheet value of net derivative liabilities moved from £51.1m to £11.7m at 31 March 2014.

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.

The company has £245m of debt index-linked to 2041-2057 at an overall real rate of 1.99%.

As a result of these initiatives South West Water's cost of finance is amongst the lowest in the industry.

At 31 March 2014 the fair value of the company's non-current borrowings was £1,542.3m (2013: £1,554.1) which is less than its book value as detailed in note 22 to the financial statements.

CAPITAL STRUCTURE

Net debt increased by £45.3m during the year, reaching a total of £1,645.7m. The increase primarily reflects the capital spend net of retained profits for the year.

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 2014 equalled £2,958.8m, representing an increase of £43.1m (1.5%) in the year. The RCV at 31 March 2013 was £2,915.7m.

As a result, South West Water's net debt to RCV has increased to 56%, remaining in line with Ofwat's optimum range of 55% to 65%.

TREASURY POLICIES

South West Water ensures that there is the funding to meet foreseeable needs to maintain reasonable headroom for future contingencies and to manage interest rate risk. The company enters into certain structured financing transactions that have and are expected to provide an improved return on surplus funds and overall interest rate performance. It operates only within policies approved by the Board and undertakes no speculative trading activity.

The Board regularly monitors expected financing needs for at least the next 12 months. These are intended to be met for the coming year from existing cash balances, loan facilities and operating cash flows.

The company has considerable financial resources. The Directors therefore believe that it is well placed to manage its business risks despite the ongoing uncertainties of the current economic environment.

All South West Water's funding is treated for regulatory purposes as ring-fenced. This means that funds raised by, or for, the company are not available as long-term funding for other areas of the Pennon Group.

GOING CONCERN

The Directors have a reasonable expectation that the company has adequate resources to continue its operational existence for the foreseeable future and considers the business model, strategy and operations are sustainable. They therefore have continued to adopt the going concern basis in preparing the financial statements.

TAXATION OBJECTIVES AND POLICIES

Our tax strategy, as approved by the Board, is to ensure we do not engage in any practices which avoid paying tax at the appropriate levels. We manage the taxes we pay having regard to the interests of our investors and our long-term relationship with the tax authorities. We will consider bona-fide arrangements which are integral to our business and which qualify for tax exemption or relief.

TAX CONTRIBUTION

The total current tax charge for the year of £28.6m was less than the charge which would have arisen had the accounting profit before tax of £162.2m been taxed at the statutory rate of 23%. A reconciliation is provided in note 9 to the financial statements.

The company made a net payment of £44.1m of UK corporation tax in the year (2012/13: £34.0m). The company's total tax contribution extends significantly beyond the UK corporation tax charge.

In addition to corporation tax the most significant taxes involved, together with their profit impact, were:

- Value Added Tax (VAT) of £47m was recovered by the company from HMRC. The repayment has arisen chiefly as a result of operational and capital expenditure. VAT has no material impact on profit before tax
- employment taxes of £12m including employees' Pay As You Earn (PAYE) and total National Insurance Contributions (NICs).
- Fuel Excise Duty of £1m related to transport costs. This reduces profit before tax
- Carbon Reduction Commitment payment for the company was £2m. This reduces profit before tax.

The corporation tax rate for 2013/14 used to calculate the current year's tax is 23%. The corporation tax rate has been reduced to 21% for 2014/15 and is expected to fall further, subject to legislation being enacted, to 20% from 1 April 2015.

PENSIONS

The company is a member of the Pennon Group's defined benefit pension schemes for certain employees of South West Water. The main schemes were closed to new entrants on or before 1 April 2008.

At 31 March 2014 the company's pension schemes showed a deficit (before deferred tax) of £60.8m (2012/13 £78.4m), the decrease primarily reflecting an increase in schemes' asset values.

The revision to IAS 19, effective in 2013/14, resulted in a net finance cost in 2013/14 of £3.4m (2012/13 of £3.1m). A further c. £0.5m was charged to operating profit to recognise administration costs. Opening pension liabilities reduced by c. £8.2m as at 31 March 2013 as a result of the change. South West Water's cash contributions to the schemes remain within Ofwat's Final Determination for the K5 period. The last actuarial valuation of the main scheme was at 31 March 2010 and the triennial valuation at 31 March 2013 is currently being finalised.

INSURANCE

South West Water manages its property and third party liability risks through insurance policies that mainly cover property, motor, business interruption, public liability, environmental pollution and employers' liability.

The company uses three tiers of insurance to cover operating risks:

- Self-insurance – pay a moderate excess on most claims
- Cover by the Pennon Group's subsidiary (Peninsula Insurance Limited) of the layer of risk between the self-insurance and the cover provided by external insurers
- Cover provided by the external insurance market, arranged by our brokers with insurance companies which have good credit ratings.

K5 OUTPERFORMANCE

In previous K periods, South West Water has 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 is allowing an additional c.£60m in improving services to customers through:

- upgrading assets in key bathing waters by accelerating capital investment
- maintaining and enhancing customers' private sewers that have been adopted since the private sewer transfer in October 2011
- tackling customer affordability through debt initiatives.

OUTLOOK

South West Water continues to focus on efficient service delivery, improvements in service to customers, and the satisfaction of its regulatory and legislative obligations. We are on track to outperform the K5 regulatory contract, including the delivery of targeted cost efficiencies.

With an 'enhanced' business plan for K6, South West Water gains a number of reputational, financial and procedural benefits. Ofwat's "do no harm" principle will ensure that we will not be disadvantaged by receiving our Draft Determination at an earlier stage than other companies. The benefits of reaching this part of the process and focusing on implementation of the business plan cannot be underestimated.

This benefits the company, our customers and investors by providing significantly greater clarity and certainty, enabling us to begin to deliver our Business Plan now.

The new Water Act was enacted in May 2014. As well as setting out a range of reforms for the water sector in England, the Act enables further retail and wholesale competition. Preparations are underway with the retail market opening from April 2017. The impact of long-term competition within upstream activities is also being considered.

ECONOMIC SUSTAINABILITY

Through the people we employ and the contractors, suppliers and partner organisations that we work alongside, South West Water plays a significant role in the economy of the region. Our strategies are designed to deliver long-term value to our investors and shareholders, ensuring we are as efficient as possible while minimising the cost to our customers.

SUPPORTING REGIONAL ECONOMIC GROWTH

The major investment we have made in water and wastewater services since privatisation has helped support regional economic growth. Key sectors such as agriculture and tourism rely on us to deliver high quality services while also protecting and enhancing the natural environment which is so intrinsically linked to their own long-term success and prosperity.

On a wider level, our positive economic ripple effect spans a variety of sectors. From the construction and engineering firms used to deliver many of our key projects through to our use of third-party clerical and creative services, the investment made with our supply chain brings major economic benefits.

Recent studies show that our activities support more than 4,000 jobs in the regional economy, in addition to the 1,400 engineers, technicians, scientists, office staff and other skilled professionals directly employed by the company.

STAYING PROFITABLE AND EFFICIENT

South West Water continues to target innovative ways to reduce operational costs and mitigate potential volatility in the price of energy, chemicals and other essential raw materials.

In recent years our adoption of new or enhanced technologies such as remote network monitoring and control has helped us manage our systems, processes and staff more efficiently.

We also target low-cost sustainable solutions. This includes initiatives such as Upstream Thinking, and more recently Downstream Thinking, which look at how intervention at catchment level can reduce the need for infrastructure intensive methods of water and wastewater management.

Communication technologies are also a key part of our strategy for improving operational efficiency.

Through PUROS (Phased Utilisation of Remote Operating Systems) we are improving the way information is gathered and disseminated around the business. Remote technologies are giving us greater control over our resources and ensuring we can respond to any issues more quickly and effectively.

Advances in technology in areas such as drinking water treatment also offer scope for reducing the costs of our operations. The new drinking water treatment works for North Plymouth, planned for the 2015-20 period, will utilise cutting edge technology that is more cost-effective than traditional water treatment methods.

Investments in this type of scheme are vital to ensure a sustainable future for our business.

Alongside the optimisation of our assets and networks, our growing use of renewable energy schemes is designed to help minimise our operational costs. As part of our energy strategy this is complemented by our ongoing work to foster a culture of efficiency and promote energy-saving within our workforce.

RESPONSIBLE FINANCING

Underpinning our business activities are our policies relating to responsible financing.

We take every step necessary to ensure our borrowing and financial commitments are managed appropriately. This includes ensuring that sufficient funding is available to meet foreseeable needs, maintain reasonable headroom for contingencies and manage interest rate risk.

Full details of our treasury and financing policies can be found on note 3 of the financial statements.

SKILLS FOR THE FUTURE

To be economically sustainable it is vital we have the right people and skills in place for the long term. This includes recruiting and training the next generation of employees through our apprenticeship scheme and ensuring we have the leadership and management skills to successfully navigate the business through future challenges and opportunities.

A SUSTAINABLE SUPPLY CHAIN

In 2013/14 approximately £100m worth of order value was placed with companies with a South West base. It is our aim to work with forward-thinking companies whose policies and approach mirror our own. Our supplier assessment is designed to cover environmental, social and financial stability, ensuring rigorous occupational health and safety policies and strong corporate governance.

Furthermore, we encourage and promote a culture of innovation and the sharing of ideas through our supplier forum and other cross-company initiatives.

OUR PERFORMANCE: PEOPLE AND COMMUNITY

The relationships we have with the different communities we serve are extremely important. Through understanding their needs, preferences and issues we can take a more informed and collaborative approach to the way the services they rely on are planned and delivered.

The past year has seen a significant amount of community engagement, largely due to activities undertaken in support of the 2015-20 Business Plan. This includes our largest ever customer consultation, which was launched in July 2013. Designed to gauge customer priorities for future investment, the formal research element was supported by a region-wide media campaign, presence at numerous local and community-based events, public talks, and outreach activities including a 'face-to-face' campaign delivered in partnership with a local radio station.

Other examples of our community engagement work during 2013/14 include:

COMMUNITY SPONSORSHIP

In 2013/14 we provided over £50,000 worth of support for community projects and organisations.

Each year our sponsorship is targeted at activities linked to the themes of water, benefitting the environment, and promoting youth participation.

Examples in the past year include:

- Northern Devon Sustainability Energy (social enterprise funding for advice sessions relating to energy usage and tackling fuel poverty)
- Cornwall Mammal Club (for the purchase of dormouse boxes to be used for surveys in West Cornwall)
- Surf Life Saving GB's Nipper Championships (500+ young people competing in life-saving orientated watersports events)
- Inland water safety awareness training for members of the Surf Life Saving GB in order to provide essential flood rescue services in case of any major incidents.

ACCESS AND RECREATION

The South West Lakes Trust (SWLT) manages over 12,000 acres of recreational space at 50 of our inland water sites. Walking, cycling, fishing, wakeboarding, and sailing are just a few of the activities available to our region's residents and visitors. The Trust also organises activities and events such as family wildlife watches, bat walks, craft fairs and treasure hunts. In 2013/14 more than 2 million people visited our sites for recreational purposes.

Furthermore, we encourage people to take an interest in the water industry and water cycle through 'Heritage Open Days' at our operational sites. In 2013/14 we opened two sites, including Roadford Dam, with a record 285 members of the public attending.

APPRENTICES

South West Water recruited 23 new apprentices in 2013/14, taking the current total to 43 across all directorates. In partnership with local educational establishments (e.g. South Devon College), the expansion of our apprenticeship programme has significant benefits for the economic and social sustainability of our company and our region.

It allows us to help shape and develop the next generation of water industry professionals and ensures a legacy for the skills and knowledge that are integral to our business.

HEALTH AND SAFETY

The health and safety of our employees is our foremost concern and we have rigorous health and safety systems, policies and procedures.

Tragically, on the 30 December 2013 there was an incident at Falmouth Wastewater Treatment Works which involved the death of a member of our wastewater team.

As the coroner's inquest to establish the material facts relating to the death has yet to take place, this incident is not included in our 2013/14 figures for RIDDOR (Reporting of Injuries, Diseases and Dangerous Occurrences Regulations).

We continually review our health and safety performance and make improvements as necessary to ensure best working practice. Our TAP ('Think, Act, Prevent') campaign was launched in 2011 to promote internal awareness of health and safety issues. Assigned health and safety representatives, manager's training days, and regular meetings of the Health and Safety Management Steering Group are some of the other measures in place to support the ongoing health, safety and wellbeing of our staff.

EMPLOYEE DEVELOPMENT

It is our ambition to be recognised as one of the best companies to work for in the South West. Our 'People Strategy', which was rolled out in 2012/13, is designed to foster a culture of support and motivation for staff. Various programmes are in place to encourage career development and we continue to expand these to ensure we have the right balance of skills for the years ahead.

In the past year our employee development programme has included:

- a major upskilling programme for our operational staff
- 30 participants on the GROW programme for personal development
- 28 participants on the LEAD 2020 Leadership Development Programme
- 24 managers completing the Management For Success scheme.

Investors in People (IIP) has ranked South West Water in the top 1% of employers and recognised us with 'silver' IIP status.

BEING A GOOD NEIGHBOUR - SUPPORT DURING CONSTRUCTION SCHEMES

Construction activities, including repairs to our assets and networks, can cause disturbances or disruption to local communities. This may include increased noise, traffic congestion or roadworks.

We plan every scheme thoroughly to try and ensure that the impact on people's lives is minimised. This includes working with our construction partners, local councils, highways agency, property-owners, and businesses to find the most agreeable solution.

In cases in which our activities could potentially have a negative economic impact (for example roadworks preventing or reducing footfall to retailers) we also look at how we can offer support through compensatory measures such as marketing and promotion.

In every case we aim to work professionally and efficiently to complete the work as quickly as it is practicable to do so.

INNOVATIVE COMMUNICATIONS: THE BEACHLIVE PROJECT

Launched in 2011 in partnership with the Environment Agency, tourism leaders and beach managers, BeachLive is South West Water's award-winning online portal for bathing water quality information.

Providing real-time updates on CSO discharges using a colour-coded alert system, the service is designed to allow beach-users to make more informed decisions on where to swim and enjoy watersports. Supplementary visitor and weather information is also provided.

The scheme initially provided updates and information on 22 beaches across Devon and Cornwall and has subsequently been expanded. In 2013 the addition of four new beaches brought the total number of beaches covered to 44.

Work has also been carried out to make the service more user-friendly, including making it more compatible for use on smartphones and tablets.

OUTLOOK

South West Water customers attach value to the company having a positive effect on the community and regional economy. Our Business Plan to 2020 highlights some of the investments we plan to make in K6 (2015-20) in support of the following key 'outcome' area:

BENEFITING THE COMMUNITY

In addition to our investment in protecting bathing and shellfish waters this also includes new education and apprenticeship opportunities for young people in the region, support for recreational and leisure activities and support for the regional economy through our ongoing service delivery, investment and improvements. Our role in the development of a new University Technical College (UTC) in Devon will bring both economic and social benefits. Health and safety improvements will also be targeted through investment of over £20m.

SOCIAL SUSTAINABILITY

As the providers of an essential service we have a responsibility and vested interest in understanding and meeting the needs of the various communities across our service area. It is our aim to be a 'good neighbour', having a positive effect on the people we serve, those we employ, and the quality of life they enjoy.

LISTENING TO OUR CUSTOMERS AND STAKEHOLDERS

In the past year we have carried out an unprecedented level of engagement with customer and stakeholder groups across the region, largely in support of the Business Plan to 2020, which received the backing of 84% of customers prior to its publication in December 2013.

From focus groups and formal surveys to radio and digital media campaigns every effort was made to gauge customer and stakeholder opinion on a range of issues, including priorities for future services and the impact of potential investment scenarios on the average household bill.

Each stage of our research and engagement was challenged and subsequently endorsed by the WaterFuture Customer Panel – an independently-chaired panel of customer, stakeholder and regulatory group representatives tasked with ensuring the plan would strike a sustainable balance of activity and investment.

The feedback we received throughout the process enabled us to identify eight 'outcomes' for future services along with a raft of performance measures, targets and incentives. The quality of our engagement was highlighted by Ofwat in their review of our plan, which saw us fast-tracked for Draft Determination in April 2014.

Details of our engagement and the resultant Business Plan, plus updates, can be found at southwestwater.co.uk/waterfuture.

ENGAGING WITH THE COMMUNITY

From our education programme through to our employee volunteer days and community sponsorship, we promote and support activities which help improve the relationships we have with the region's communities.

Heritage Open Days provide valuable opportunities for members of the public to find out more about the services they receive. In 2013 two such days were hosted – at Roadford Dam and Gun Cliff Wastewater Treatment Works - with a record 285 attendees in total.

On a local level, some wastewater operations teams also invited schools and groups on tours of our larger wastewater treatment works. In 2013 this included staff from the National Marine Aquarium in Plymouth and the 10th Exeter (St James) Scout Group who visited Countess Wear Wastewater Treatment Works.

VOLUNTEERING

From beach cleans to tree-planting and habitat management, South West Water staff are encouraged and supported to take part in activities which help improve the communities in which we all live and work. Porthtown, Whitsand Bay, Widemouth Bay and Upton Cove were among the areas targeted in 2013 through beach cleans.

SUPPORT FOR EDUCATION

Developing the local skills base is vital to the sustainability of our region and our business. As such, South West Water has close links with many of the region's educational establishments.

In addition to our apprenticeship scheme, which is delivered in partnership with South Devon College, we also provide support for education through:

- educational materials and school talks for primary and secondary schools. In 2013/14 this included attendance of the South West Water caravan team at 17 schools around the region
- work experience placements for school and university students
- guest lecturing on university courses (Exeter, Plymouth and Bristol universities).

GOVERNANCE

CHAIRMAN'S INTRODUCTION

Good governance reduces risk and adds value to our business. As such, the South West Water Board is committed to high standards of corporate governance and supports the principles laid down in the revised UK Corporate Governance Code.

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.

South West Water and its parent company, Pennon Group Plc, are committed to operating to the highest standards of board leadership and governance including transparency of reporting to investors, customers, regulators and other stakeholders.

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.

In response to, and in accordance with Ofwat's board leadership, transparency and governance principles and the timetable for meeting those principles South West Water is committed to implementing changes to its Board structure and governance to ensure full compliance by 31 March 2015. In order to align the existing governance framework more explicitly with the UK Corporate Governance Code and Ofwat's governance principles, the Board has established Audit and Sustainability Committees which have been in operation during the year, and laterly Remuneration and Nomination Committees.

Furthermore, recruitment is underway for the appointment of two additional Non-executive Directors which will result in a Board Composition of four independent Non-executive Directors and four Executive Directors. Before April 2015 I will step down as Chairman and one of the Non-executive Directors will be appointed as Chairman to replace me.

We will continue to regularly review our governance structures, ensuring we continue to carry out our business in a transparent way, designed to secure the company's long-term success and profitability.

BOARD COMPOSITION

The South West Water Board of Directors at the end of the 2013/14 financial year comprised the Chairman, four Executive Directors, and two Non-executive Directors. The Board considers that both of the two Non-executive Directors were 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.

NEW GOVERNANCE AND REMUNERATION REPORTING

We have updated our governance and corporate reporting arrangements in accordance with the requirements of the updated UK Corporate Governance Code and the new reporting regulations which came into effect for our 2013/14 financial reporting year. The principal changes we have made to implement with these new reporting requirements are:

- inclusion of a strategic report in the Annual Report this year instead of a business review. The strategic report contains a review of the company's business, a description of the principal risks and uncertainties facing the company and a balanced and comprehensive analysis of the development and performance of the company's business during the year in addition to the position of the company's business at the end of the year. We set out the main trends and factors likely to affect the future development, performance and position of the company's business, information about environmental matters, the company's employees and community issues as well as a description of the company's strategy, its business model and diversity information

- additional information in the Audit Committee report setting out the significant issues relating to the financial statements that the Committee considered and addressed during the year as well as the key areas of focus
- a restructured and enhanced directors' remuneration report.

BOARD EFFECTIVENESS

The Board is committed to remaining effective and recognises that to do so it must ensure that it has the right balance of skills, independence and knowledge of the company to enable it to discharge its duties and responsibilities. This is particularly important to ensure that the Board is best placed to support the future strategy.

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.

BOARD OF DIRECTORS

KEN HARVEY

Chairman

Appointed on 1 March 1997, Ken Harvey was formerly chairman and chief executive of Norweb Plc. He held a number of appointments within Southern Electricity and became Engineering Director of London Electricity and then Deputy Chairman. He has also been chairman of a number of limited and private equity funded companies.

CHRIS LOUGHLIN

Chief Executive

Appointed on 1 August 2006, Chris Loughlin was previously chief operating officer with Lloyds Register. Earlier in his career was an Executive Director of British Nuclear Fuels Plc and executive chairman of Magnox Electric Plc. He was also a senior diplomat in the British Embassy, Tokyo.

Between April 2008 and March 2012 Chris was chairman of Water UK. He is currently vice-chairman of the Cornwall Local Enterprise Partnership, President of the Institute of Water and a trustee and member of the audit committee of the global charity, WaterAid.

DR STEPHEN BIRD

Operations Director

Stephen was appointed on 1 March 2000. Prior to joining South West Water, he held posts in the Welsh Water Authority, National Rivers Authority and Wallace Evans Consultants as an environmental consultant.

Stephen is Chairman of the Water UK Marine Network. He is a Board Member of UK Water Industry Research Limited and is a member of the Heart of the South West Local Enterprise Partnership Board. He is also a Fellow of the Chartered Institute of Environmental Managers.

SUSAN DAVY

Finance and Regulatory Director

Susan was appointed on 31 August 2007 having previously worked at Yorkshire Water where she was Head of Regulation.

She occupied a number of senior finance posts for Yorkshire Water including Head of Finance in their Waste Water Unit and Head of Finance for Brey Utilities, a joint venture company owned by Yorkshire

Water and Earthtech Engineering Ltd. She is a council member of Water UK and a graduate qualified chartered accountant.

MARTIN HAGEN

Non-executive Director

Martin Hagen's second 3-year appointment as Non-executive Director commenced on 1 September 2013. He was formerly at Deloitte where he was Senior Partner of the firm's West of England region.

Martin is currently Deputy Chairman of the Financial Conduct Authority's Regulatory Decisions Committee, Governor and Audit Committee Chair of the University of the West of England and a member of the Audit and Risk Assurance Committee of the Department of Work and Pensions (DWP).

MONICA READ

Customer Relations and Business Development Director

Monica joined South West Water in 1992 and held a wide range of roles across the company prior to her appointment on 1 September 2002. Prior to working for South West Water, she worked for accountants Touche Ross & Co, both in London and overseas. She is a member of the Institute of Chartered Accountants and a graduate in Environmental Science. Monica is a Trustee of the South West Lakes Trust and has a special interest in sustainability issues.

MATTHEW TAYLOR

Non Executive Director

Lord Matthew Taylor's second 3-year appointment as Non-executive Director commenced on 1 March 2013. Formerly MP for Truro and St. Austell (1987-2010), Matthew is Chairman of the National Housing Federation (the Housing Association trade body) and of the St Austell Eco-Town Strategic Partnership. He led the Government's recent National Planning Practice Guidance review and conducted the last Government's Review of Planning in relation to the Rural Economy and Affordable Housing ('Living Working Countryside', 2008).

The Directors on the Board and their attendance at the 11 scheduled meetings of the Board during 2013/14 are as follows:

Board membership		Appointment date	Attendance /11
Chairman Ken Harvey	Chairman of the Nomination Committee	March 1997	11/11
Executive Directors Chris Loughlin Dr Stephen Bird Susan Davy Monica Read	Chief Executive Operations Director Finance and Regulatory Director Customer Relations and Business Development Director	August 2006 March 2000 August 2007 September 2002	11/11 11/11 11/11 11/11
Non-executive Directors Martin Hagen Lord Matthew Taylor	Chairman of the Audit and Remuneration Committees Chairman of the Sustainability Committee	September 2013 March 2013	11/11 11/11

In addition to the scheduled monthly board meetings, there were also a number of additional board meetings held to discuss the PR14 Price Review.

All directors are equally accountable for the proper stewardship of the company's affairs with the Non-executive Directors having a particular responsibility for ensuring that strategies proposed for the development of the business are critically reviewed. The Non-executive Directors also critically examine the operational and financial performance of the company and fulfil a key role in corporate accountability through their membership of the governance Committees of the Board.

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 customers. In addition to a monthly review of customer contact and complaint analysis, the Board is regularly 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. In preparation for, and during the PR14 price review, South West Water undertook its most extensive customer engagement programme which gave us a greater understanding of our customers' needs and preferences.

This included extending the range, scope and quality of our customer communications. The Non-executive Directors took an active role in the customer engagement programme, attending a number of focus group sessions.

HOW THE BOARD OPERATES

The Board has a schedule of matters reserved for its decision and delegates more detailed consideration of certain matters to Board Committees. The matters reserved to the Board include:

- the approval of financial statements including the Annual Report & Accounts
- all acquisitions and disposals
- major items of capital expenditure
- authority levels for other expenditure
- risk management process and monitoring of risks
- approval of the strategic plan and annual operating budgets
- company policies, procedures and delegations.

Written reports are circulated in advance of Board meetings from the Executive Directors on matters within their respective areas of the business. 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.

Directors have access to the advice and services of the Company Secretary and the Board has an established procedure whereby Directors, in order to fulfil their duties, may seek independent professional advice at the company's expense.

The training needs of Directors are reviewed as part of the Board's performance evaluation process each year. Training consists of attendance at external courses organised by professional advisers and also internal presentations from senior management.

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 condition.

PERFORMANCE EVALUATION

The Board continues to have well developed internal procedures to evaluate the performance of the whole Board, the Chairman, each individual director and the Company Secretary. All participants' views were sought via a questionnaire on a range of questions which were specifically designed to ensure objective evaluation of performance. Responses were then summarised and evaluated for the Board to consider and determine whether any changes should be made to be more effective or to improve governance.

INTERNAL CONTROL

The Board is responsible for maintaining the company's system of internal control. The system is designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement or loss. There is an ongoing process for identifying, evaluating and managing the significant risks faced by the company that has been in place throughout 2013/14 and up to the date of the approval of this Annual Report and Financial Statements.

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

In addition the Audit Committee regularly reviews the operation and effectiveness of the internal control framework and annually reviews the scope of work, authority and resources of the company's internal audit activities. For 2013/14 and up to the date of the approval of the Annual Report and Accounts, both the audit committee and the Board were satisfied with the effectiveness of the company's risk management policy and the internal control framework and their operation within the company.

BOARD COMMITTEES

During this year South West Water has made enhancements to the Board Governance processes including formalising appropriate Committees which mirror the requirements of the UK Corporate Governance Code.

A range of key matters are delegated to the Board's Governance Committees as set out on pages 40 to 47 of this corporate governance report.

The terms of reference of each of the Board's committees are set out on the company's website (southwestwater.co.uk) or available upon request to the Company Secretary.

AUDIT COMMITTEE

INTRODUCTION

It is vital that business is carried out in a transparent way with detailed and thorough systems in place to ensure accountability for, and scrutiny of, strategic decision-making, risk management and the reporting of performance.

The South West Water Audit Committee provides a key element of the company's governance structure, with members considered to have the required expertise to challenge and evaluate how well the company is working towards its strategic goals and how accurately this is communicated. This includes ensuring that the interests of shareholders and other stakeholders are protected and that responsible business practices are adhered to. The Committee's remit is to achieve compliance with best practice in terms of corporate governance and financial reporting, and act as a link between external auditors and Board Directors.

Furthermore, the Audit Committee enables Non-executive Directors to use their individual understandings and experience of the wider business, political and economic spheres to provide objective insight on how the company is managing both the risks and opportunities afforded to it. Our aim is to ensure that South West Water continues to make sound and informed judgements on its business activities and that the resultant outputs are communicated in a fair and balanced way.

Membership		Attendance /3
Martin Hagen	Chairman	3/3
Lord Matthew Taylor	Non-executive Director	3/3

ROLE OF THE AUDIT COMMITTEE

The Audit Committee is responsible for providing effective oversight and governance over the company's financial reporting, including the adequacy of related disclosures, the performance of assurance provided during the year, the internal financial control environment and the processes in place to monitor this.

The full terms of reference are available on our website (southwestwater.co.uk).

The members of the Committee receive updates in financial reporting and the company's regulatory framework in various forms throughout the year. The Chief Executive, Executive Directors, Head of Pennon Group.

Internal Audit and the external auditors normally attend by invitation, all meetings of the Committee. Other members of senior management are also invited to attend as appropriate.

The Committee has an established annual calendar of business which assists in ensuring that it manages its affairs efficiently and effectively throughout the year concentrating on the key matters which affect the company.

The most significant matters which the Committee considered and made decision on during the year are set out below.

Financial reporting	Internal control and compliance	External auditors	Risk management	Governance
<p>Monitored the integrity of the financial statements of the company and the half year and full year results including reviewing significant financial reporting judgements contained in the statements.</p> <p>Considered and approved a process for confirming and recommending to the Board that the 2013/14 Annual Report & Financial Statements is fair, balanced and understandable.</p>	<p>Reviewed quarterly internal audit reports on audit reviews across the company during the year.</p> <p>Reviewed the integrated internal control framework for the company.</p> <p>Considered the outcome of Quality Assurance reviews and ISO accreditations.</p>	<p>Considered the auditors' report on their review of the 2013/14 half year results and key findings.</p> <p>Reviewed and monitored audit/non-audit expenditure during 2013/14.</p> <p>Considered and approved the 2013/14 audit plan and audit fee proposal and set performance expectations for the external auditor.</p> <p>Considered the initial results of the 2013/14 audit.</p>	<p>Reviewed risk management framework and compliance with that framework during 2013/14.</p> <p>Reviewed the assessment of the risks by the Executive Directors.</p> <p>Received as part of the risk management review the annual report on any whistle-blowing.</p>	<p>Considered and approved new annual report disclosure requirements including this audit report.</p> <p>Held separate meetings with the external auditors and the internal group audit manager without members of management being present.</p>

GOING CONCERN

As part of its review of the annual report and financial statements the committee considered whether the company had adequate financial resources to continue trading as a going concern.

The Committee has considered, amongst other matters,

- a review of the company's financial projections
- stress testing of the financial budget and forecasts
- a review of the cash and committed borrowing facilities available as well as consideration of the company's capital adequacy
- consideration of the company's strategic business model.

Regulatory reform, and in particular the price determination and Licence change impacts have, to date, followed the Government's evolutionary objective. A number of the existing features of the regulatory regime have been retained which impact long-term financing – not least an RCV based return linked to RPI, with assets remaining 'ring fenced' in the wholesale business, with a 25-year rolling Licence.

Given the recent announcement that the company has pre-qualified with an enhanced assessment, based on a Business Plan submitted by the company to the regulator that is financeable, it is considered that the business model, strategy and operations are sustainable.

In conclusion, the Directors have a reasonable expectation that the company has adequate resources available to it to continue in operational existence for the foreseeable future and have therefore continued to adopt the going concern policy in preparing the financial statements.

ACCOUNTING POLICIES AND CRITICAL ACCOUNTING JUDGEMENTS

As part of its monitoring of the integrity of the financial statements, the Committee reviews whether suitable accounting policies have been adopted, whether management has made appropriate estimates and judgements and also seeks support from the external auditors to assess them.

The Committee looked carefully at those aspects of the financial statements which required significant accounting judgement or where there was estimation uncertainty. These areas are explained in note 4 of the financial statements. The Committee paid particular attention to the following areas in the year ended 31 March 2014:

<p>Provision for doubtful debt</p> <p>Throughout the year and particularly at each balance sheet date the company evaluates the collectability of trade receivables and records a provision for doubtful debts.</p> <p>This provision is based on segmenting the company customer base and including a provision % after considering the relative age of accounts, collections history, write-offs and future collectability.</p>	<p>The Audit Committee has considered the appropriateness of the doubtful debt provisioning in the half and full year results. There have been no changes in the methodology for calculating this provision during 2013/14 and the percentage applied within the provisioning process has remained consistent with last year.</p> <p>At the year end the external auditors reported on the work performed. The Committee discussed the results of this report and asked questions of the Executive Directors. The approach and key assumptions made by management were considered appropriate and accepted by the Audit Committee.</p>
<p>Metered Accrual</p> <p>South West Water's billing cycle for measured customers is in arrears and therefore at the balance sheet date an estimate of revenue recognised within the year is required.</p>	<p>The metered accrual is a system driven automated calculation. The accrual is reviewed by management and the assumptions used in the calculation are considered appropriate and consistent with the prior year. A retrospective review of the prior year accrual against the actual amounts billed identified a difference of c.0.2%, and is not considered to be significant by the Audit Committee.</p>
<p>Fixed asset depreciation charge</p> <p>Capital expenditure and asset related charges are a significant balance within South West Water's financial statements. The estimates of asset lives and thus depreciation charges are a significant judgement.</p>	<p>The Audit Committee has considered the appropriateness of the accounting for capital expenditure and the asset lives assumed.</p> <p>There have been no material changes in the process or procedures in the application of depreciation, nor have any asset lives been amended in the past year.</p> <p>A review was completed during the year to ensure that studies which are undertaken for projects are appropriately included as an incremental cost of the project and have the appropriate asset life attached</p> <p>The reporting from external auditors has been</p>

	reviewed, where specific comment and analysis has been made on this judgement. The useful lives applied were within the range applied by others within the sector.
--	--

The Committee is satisfied that each of the matters set out above had been fully and adequately addressed by the Executive Directors, appropriately tested and reviewed by the external auditor and that the disclosures made in the Annual Report and Financial Statements are appropriate.

EXTERNAL AUDIT

The company's Audit Committee is actively engaged with the auditors PricewaterhouseCoopers LLP who were appointed as auditors in 2006 following a comprehensive competitive tender process.

Annually, the Audit Committee reviews the external auditors' plan and considers the effectiveness as well as their independence, bearing in mind that it is recognised there is an ongoing need to use our auditors' firm for some non-audit services.

PROVISION FOR NON-AUDIT

The Committee has a policy for the engagement of the external auditor's firm for non-audit work which involves setting out the reasons why the auditor's firm should be appointed for any material work. The Committee carefully reviews whether it is necessary for the auditor's firm to carry out such work and will only grant approval for their appointment if they are satisfied that the auditor's independence and objectivity is fully safeguarded. Also if there is another accounting firm that can be engaged to undertake the non-audit services then such firm would be chosen in preference to the external auditors.

Set out on note 7 of the financial statements is the level of fees paid to the company's auditors' firm for audit services, audit related services and non-audit services.

The increase in total fees results from the significant amount of assurance required over the submission of the 2015-2020 Business Plan and fees for pension advisory services.

The Committee considered that the external auditors were best placed to provide certain agreed upon procedures and advisory services in connection with South West Water's PR14 submissions because of their knowledge of South West Water's business, accounting policies, practices and in particular the synergies available from the Regulatory Accounts Process. The Committee also considered that the external auditors were best placed to provide pension advisory services because of their relevant experience in the water sector.

AUDIT FIRM TENDERING

During the year the decision was made that Pennon Group would re-tender its audit services across the group. The process for tendering followed the notes on best practice in respect of audit tenders published by the Financial Reporting Council in July 2013. The process followed was:

- initial identification of a selection criteria and assessment mechanism
- consideration of the candidates to be invited to tender including those outside the 'Big Four'
- discussion with the potential auditors to ensure they were free to compete under independence rules
- design of a detailed tender document and subsequent initial review of tenders received
- interviewing of the preferred candidates followed by a recommendation to the Board on the preferred appointment
- allowing for sufficient time for an orderly handover and transition involving the incoming auditor at key stages in the prior period's audit.

Subject to approval at the forthcoming Pennon Group AGM, the Board approved the appointment of Ernst & Young in February as the incoming auditor with effect from August 2014. Since February Ernst & Young have followed an orientation programme with key management in the company and attended, with the current external auditor, the meeting of the South West Water Audit Committee at which the preliminary results for the year were considered and discussed for recommendation to the Board.

RISK & ASSURANCE PLAN

The Audit Committee is responsible for ensuring appropriate risk management processes are in place and the assurance activities undertaken across the company.

During the year South West Water had in place an effective integrated assurance framework which identifies and monitors all types of assurance to enable a full evaluation of the conclusions drawn by all auditors, inspectors and reviewers from both internal and external providers.

This framework includes Pennon Group Internal Audit, annual assurance by our external financial and technical auditors of both statutory and regulatory reporting, process reviews and assurance over key projects (both external and internal as appropriate) and Quality Assurance leading to ISO certification.

INTERNAL AUDIT

South West Water utilises the Pennon Group's independent Internal Audit function, to provide effective risk based coverage over the internal control environment. This is summarised in an audit plan, approved in September each year, which is approved by the Audit Committee and updated on a rolling basis.

The Internal Audit function reviews the extent to which systems of internal control:

- are designed and operating effectively
- are adequate to manage South West Water's key risks.

The areas of the business that received attention over the past year included customer service, accounts payable, payroll and related HR processes, cash processing, credit management and debt collection.

Throughout the year the reports arising from Internal Audits are discussed with the Executive Management team. The Head of Pennon Internal Audit is invited to, and attends, South West Water Audit Committee meetings, and is also given the opportunity to discuss privately with the Audit Committee Chairman without any members of management present.

The Audit Committee has oversight responsibilities for activities completed by the Pennon Group Internal Audit department within South West Water. The Internal Audit annual plan is reviewed and approved by the South West Water Audit Committee and recommendations and findings arising from these, along with management actions to findings are considered.

ANNUAL ASSURANCE

Alongside the statutory external auditors, South West Water also engages a Technical Auditor to provide assurance over key areas of regulatory performance reporting. This assurance considers our reported performance against key regulatory outputs and measures.

PROJECT ASSURANCE

Where required, South West Water will consider assurance over key projects and engage external assurance providers where appropriate to review progress and outputs of these projects. During 2013/14 this included the significant range of assurance to support the 2015-20 Business Plan provided by both Financial and Technical Auditors.

QUALITY ASSURANCE AND INTERNAL REVIEWS

The South West Water Audit Committee also considers the resources for carrying out internal reviews in key company specific areas and endorses and acts on findings from these reviews carried out within the company. There is a programme of internal audits coordinated by the Quality Assurance Department as part of the company's ISO 9001:2008 and ISO 14001:2004 certifications.

South West Water also has the following quality accreditations/certifications:

- ISO 9001: 2008 (quality management)
- SO14001: 2004 (environmental management)
- ISO 27001: 2005 (information security)
- ISO 17025: 2005 (laboratories and sampling).

RISK MANAGEMENT AND ASSESSMENT

A full risk and control assessment is undertaken annually, and regularly updated, to identify both financial and non-financial risks. At Audit Committee meetings details of any new highlevel 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 has in place and adheres to a 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. The key risks affecting the company are detailed in pages 70 to 75.

At the end of the year the Nomination and Remuneration Committees were established, however no meetings took place during 2013/14.

NOMINATION COMMITTEE

Membership	
Ken Harvey	Chairman
Martin Hagen	Non-executive Director
Lord Matthew Taylor	Non-executive Director

The Nomination Committee is responsible for considering and recommending to the Board persons who are appropriate for appointment as Executive and Non-executive Directors and for other senior management roles, so as to maintain an appropriate balance of skills and experience within the company and on the Board.

This Committee will meet to select and recommend appointments to the Board. The terms of reference of the Nomination Committee are available on our website.

GENDER DIVERSITY

The company has a number of policies embracing workplace matters, including non-discrimination and equal opportunities policies.

Membership	Female membership %
The Board	26%
Senior Management	15%
Company	21%

REMUNERATION COMMITTEE

Membership	
Martin Hagen	Chairman
Lord Matthew Taylor	Non-executive Director

The Remuneration Committee's principal function is to support the company's overall remuneration policy. The key terms of reference for the Remuneration committee are available on our website.

SUSTAINABILITY COMMITTEE

INTRODUCTION

Achieving sustainability requires the careful balancing of financial performance, environmental responsibilities and social commitments. By striking the right balance a company will grow and prosper while having a positive effect on the communities and ecosystems in which it operates.

South West Water's Sustainability Committee has been established to monitor, challenge and ensure the transparency of reporting in terms of the company's social, economic and environmental sustainability. South West Water is one of the largest companies in the South West region, a major employer and, in essence, the caretaker of many of the South West's most sensitive and economically-vital natural assets. As such, the company has an ambition, a financial motivation and an obligation to ensure that the long-term effects of its business decisions and activities are in the best interests of the people, economy and environment of the region.

The Committee helps to facilitate this through its capacity to provide both objective scrutiny and steer on matters relating to sustainable business practice. This includes the setting of, and assessing of performance against, sustainability targets which help drive the business towards improvement in this regard.

The involvement of the Committee aids the identification and adoption of policies that conform to recognised ideals and ethics of corporate responsibility. By guiding the company towards a sustainable future we help safeguard its profitability over the long term while preserving and enhancing the reciprocal relationship that South West Water has with the immediate and wider world.

Membership		Attendance /1
Lord Matthew Taylor	Chairman	/1
Martin Hagen	Non-executive Director	/1

Formed in 2014, the Sustainability Committee is responsible for reviewing the strategies, policies, management and initiatives in the context of how the company conducts its business in a responsible and sustainable manner.

It considers the targets and performance of South West Water in the areas of: ethical business practice; community engagement; environmental, economic and workplace sustainability; and the role of the company in society.

The inaugural meeting of the Sustainability Committee considered and agreed the key terms of reference which are available on our website.

Other matters considered were:

- The approach to sustainability reporting for the year
- South West Water's progress against the sustainability targets for 2013/14
- Sustainability targets for 2014/15.

The Committee has promoted integrated reporting of its sustainability activities and these have been included within the wider strategic review.

SUSTAINABILITY TARGETS

A summary of South West Water's performance against sustainability targets for 2013/14 is outlined in the following report. Page references are provided for further information.

ENVIRONMENTAL SUSTAINABILITY

The protection of the natural world is an essential aspect of ensuring we have high quality resources available now and in the future. By working alongside partner organisations and agencies and identifying how new technology and innovation can reduce our impact we aim to deliver water and wastewater services in harmony with the ecosystems and habitats of our region.

South West Water met the majority of its environmental targets during the year. However, whilst we avoided any Category 1 (major) incidents, we did not meet our sustainability target of fewer than seven Category 1 and Category 2 (significant) incidents combined. Further work is clearly needed in order to move us closer towards our long-term aim of zero harmful pollutions. Our Business Plan to 2020 sets out the improvements we plan to make in this area between 2015-20.

TARGET	STATUS
Work in partnership with members of the Park & Stannon lakes environment group, to deliver projects which provide landscape, biodiversity and fisheries benefits at these reservoirs.	MET
Further delivery of the Upstream Thinking project outputs and promotion as best practice nationally and to stakeholders.	MET
Aim for seven or fewer Category 1 and Category 2 pollution incidents as a result of effluent discharge/storm overflow (calendar year).	NOT MET
Target greenhouse gas emissions reduction compared with 2009/10. Develop further initiatives to reduce emissions from transport through improved telematics and teleconferencing/web-based collaboration tools.	MET
Increase the installed capacity of South West Water's renewable energy plant by an additional 465kw.	MET
Review schemes to reuse and recover waste, specifically grit and screenings, and ensure use of the waste hierarchy on construction site activities.	MET

ECONOMIC SUSTAINABILITY

Through the people we employ and the contractors, suppliers and partner organisations that we work alongside, South West Water plays a significant role in the economy of the region.

Our strategies are designed to deliver long-term value to investors and shareholders, ensuring we are as efficient as possible while minimising the cost to customers.

South West Water met all economic sustainability targets during 2013/14.

TARGET	STATUS
Achieve a further 3GWh (full-year effect) energy saving through the Powerdown, pump efficiency and PUROS programmes.	MET
Develop further leadership skills and productivity focus through the employee development programme which will include: <ul style="list-style-type: none"> • Lead 2020 for senior managers • Completion of the M4S programme for at least 	MET

first and second line managers <ul style="list-style-type: none"> • GROW programme for graduates • Recruitment of up to 20 apprentices into wastewater and other areas • Upskilling in operations through the integration phase of PUROS 	
Further develop the supplier sustainability programme to identify and deliver environmental benefits in key tenders, record the carbon footprint of key and strategic suppliers and implement the supplier code of conduct.	MET

SOCIAL SUSTAINABILITY

As the providers of an essential service we have a responsibility and vested interest in understanding and meeting the needs of the various communities across the area we serve. It is our aim to be a 'good neighbour', having a positive effect on the people we serve, those we employ, and the quality of life they enjoy.

South West Water met all social sustainability targets during 2013/14.

TARGET	STATUS
Carry out research and engagement activities with our customers and stakeholders to discuss their priorities and needs to help shape our long-term and five-year investment plans.	MET
Partner with local social housing providers to run a pilot offering targeted financial and practical assistance to low-income tenants struggling with water bills.	MET
Deliver our community engagement programme by hosting two heritage open days and four employee volunteering projects. Provide support for education, youth employability and work readiness.	MET
Target a one-year RIDDOR reportable incident rate of no more than 850 per 100,000 employees within the 2013 calendar year across company activities working towards an overall aim of zero accidents in the workplace (Note: 850 per 100,000 equates to 10 or fewer RIDDOR reportable incidents).	MET
Further delivery of BeachLive project and promotion to stakeholders including improvements to web presentation for users.	MET

VERIFICATION

South West Water's sustainability performance and reporting has been audited by Carnstone Partners LLP, an independent management consultancy specialising in corporate responsibility and sustainability.

DIRECTOR'S REMUNERATION REPORT

REMUNERATION COMMITTEE

For 2013/14 South West Water's Directors remuneration has been determined by the Pennon Group Remuneration Committee. The Pennon Group Remuneration Committee is responsible for:

- advising the Board on the framework of executive remuneration for the Group
- determining the remuneration and terms of engagement of the Chairman, the Executive Directors and senior management of the Pennon Group.

The Pennon Committee comprises three Non-executive Directors and has met nine times during the year. During the year the Committee dealt with the following matters specifically relating to South West Water:

- annual review of the pay and benefits policies and practices for the staff below Board level
- annual executive salary review
- determining performance targets in respect of the annual incentive bonus plan for 2013/14
- determining bonuses and deferred bonus awards pursuant to the company's annual incentive bonus plan in respect of the year 2012/13
- approving the performance and co-investment plan awards for the year
- reviewing the annual performance evaluation results of the Committees
- approving the release of the 2010 deferred bonus share awards and the vesting of executive share options pursuant to the annual incentive bonus plan
- determining the outcome of the 2010 long-term incentive plan awards
- reviewing the operation of the annual incentive bonus plan and determining revised performance targets and the inclusion of malus and clawback provisions in the plan rules
- determining South West Water Non-executive Director fees.

Further information on the Pennon Group's Remuneration Committee can be found in the Pennon Group Plc Annual Report. A separate South West Water Remuneration Committee has been established in 2013/14. The terms of reference for this Committee are available on the company's website.

REMUNERATION DECISIONS FOR THE YEAR

For 2013/14 the basic salaries of the Executive Directors³ were increased by between 2% and 2.5%. For 2014/15 salaries have been increased at between 2.5% and 5.0%.

The bonus outturn for the Executive Directors¹ for the year were between 63% and 85%, reflecting the company's performance against corporate financial targets and the Executive Directors' individual targets. As regards the long-term incentive plan, the overall outturn for awards' vesting at the end of the three year period ending 31 March 2014 is 30.2% of the maximum. This reflected the Pennon Group's total shareholder return which exceeded the upper threshold of the waste/water comparator index performance measure but was ranked below the median of the FTSE 250. The vesting of this award is subject to the 'Underpin' being satisfied, referred to on page 53.

KEY CHANGES AND IMPROVEMENTS IN THE YEAR

During the year the remuneration policy and benefits structure has been reviewed with the assistance of external remuneration consultants. To ensure Executive Directors incentives were focused on key performance objectives for the company the corporate performance objectives for the annual incentive plan have been revised. Malus and clawback provisions in the bonus arrangements were also introduced in accordance with best practice.

No other changes have been made to the remuneration package. In particular all maximum opportunities will remain the same in 2014/15.

³ Including those with Pennon Group Plc Executive Directorships.

BEST PRACTICE REPORTING

In embracing the new reporting requirements and in an endeavour to ensure clear and transparent reporting the following sections of this remuneration report are:

- Directors' remuneration policy – this is the company's proposed policy as adopted from Pennon Group Plc, on Directors' remuneration.
- Annual report on remuneration – contains the remuneration of the Directors for the year 2013/14 including the 'single remuneration figure' table providing a value for each element of remuneration for each director (page 61), together with the details of the link between company performance and remuneration during the year.

DIRECTORS' REMUNERATION POLICY

INTRODUCTION

The remuneration policy described here is as adopted by South West Water from Pennon Group Plc.

FUTURE POLICY TABLE – EXECUTIVE DIRECTORS

The table below sets out the elements of the total remuneration package for the Executive Directors which are comprised in this Directors remuneration policy.

How the components support the strategic objectives of the company	How the component operates (including provisions for recovery or withholding of any payment)	Maximum potential value of the component	Description of framework used to assess performance
Base Salary			
Set at a competitive level to attract candidates to meet company's strategic objectives and to aid retention.	Salaries are generally reviewed annually and any changes are normally effective from 1 April each year. In normal circumstances salary increases will not be materially different to general employee pay increases but there may be exceptions such as where there has been the recruitment of a new Executive Director at an initially lower salary.	When reviewing salaries the Committee has regard to the following factors: <ul style="list-style-type: none"> • salary increases generally for all employees of the company and the Group • market rates • performance of individual and the company; and • other factors it considers relevant. There is no overall maximum.	None, although individual and company performance are one of the factors considered when reviewing salaries.
Benefits			
Benefits are provided which are consistent with the market and level of seniority and which aid retention of key skills to assist in meeting strategic objectives.	Benefits currently include the provision of a company vehicle, fuel, health insurance and life assurance. Other benefits may be provided if the Committee considers it appropriate. In the event that an Executive Director is required to relocate, relocation benefits may be provided.	The cost of insurance benefits may vary from year to year depending on individual's circumstances. There is no overall maximum benefit value but the Committee aims to ensure that the total value of benefits remains proportionate.	None

Annual bonus

<p>Linked to achievement of key performance objectives aligned to the strategy of the company</p>	<p>Annual bonuses are paid following finalisation of the financial results for the year to which they relate and paid usually 4 months after the end of the financial year.</p> <p>50% of any bonus is deferred into shares of Pennon Group Plc, which are normally released after three years. Any dividends on the shares during this period are paid to the Directors.</p> <p>The deferred bonus plan is operated in conjunction with the Pennon Group Plc's HMRC approved share option scheme (ESOS) on the basis that the pre-tax value of awards under both are the same as if the deferred bonus plan had operated alone.</p> <p>For bonuses awarded in respect of the 2014/15 financial year and going forward malus and clawback provisions apply which permit net cash bonuses and/or deferred bonuses shares to be forfeited, repaid or made subject to further conditions where the Committee considers it appropriate in the event of any significant adverse circumstances, including (but not limited to) a material failure of risk management, serious reputational damage, a financial misstatement or misconduct. Clawback may be applied for the period of three years following determination of the cash bonus.</p>	<p>The maximum bonus potential for each director is:</p> <p>C Loughlin: 100% of base salary of which 50% was cash and 50% was deferred.</p> <p>S Bird, S Davy, M Read: 75% of base salary of which 37.5% was cash and 37.5% was deferred.</p>	<p>Performance targets relate to corporate and personal objectives which are reviewed each year.</p> <p>For C Loughlin 70% and for S Bird, S Davy and M. Read 55% relates to financial targets and quantitative measures.</p> <p>The measures, weighting and threshold levels may be adjusted for future performance years.</p> <p>Following the financial year end the Committee, with advice from the Chairman of the Board and following consideration of the outturn against target by the Chairman of the Audit Committee assesses to what extent the targets are met and determines bonus levels accordingly. In doing so the Committee takes into account overall company performance and may adjust the bonus upwards or downwards for any specific factors, such as exceptional out-performance or under-performance.</p>
---	---	---	--

Long term incentive plan (performance & co-investment plan)			
Provide alignment to shareholders and longer term Pennon Group performance.	<p>Annual grant of conditional shares (or equivalent). Share awards vest dependent upon the achievement of specific performance conditions measured over a performance period of no less than three years.</p> <p>A grant is only made if the director has acquired or is due to acquire co-investment shares equivalent to one-fifth in value of the award.</p> <p>Dividend equivalents (including dividend reinvestment) may be paid on vested awards.</p> <p>An "Underpin" applies which allows the Committee to reduce or withhold vesting if the Committee is not satisfied with the underlying operational and economic performance of the company.</p>	<p>Maximum annual award for each director is:</p> <p>C Loughlin - 100% of base salary</p> <p>S Bird, S Davy, M Read - 80% of base salary.</p>	<p>The current performance condition is based on Total Shareholder Returns (TSR) of the Pennon Group with 50% based on TSR against the water/waste peer group index and 50% based on TSR against constituents of the FTSE 250 index (excluding investment trusts). No more than 30% of maximum vests for minimum performance.</p> <p>The "Underpin" evaluation includes consideration of Environmental, Social and Governance (ESG) factors and safety performance as well as financial performance.</p> <p>The Committee will keep the performance measures under review and may change the performance condition if this were considered to be aligned with the Pennon Group's interests and strategic objectives.</p>
Pension			
Provides funding for retirement and aids retention of key skills to assist in meeting the company's strategic objectives.	<p>Defined benefit pension arrangements are closed to new entrants. Defined contribution pension arrangements are available to new staff since 2008.</p> <p>A cash allowance may be provided as an alternative and/or in addition where pension limits have been reached.</p>	<p>The maximum annual pension contribution or cash allowance is 20% of salary. For Executive Directors who commenced employment prior to April 2013 the maximum annual pension contribution or cash allowance is 30% of salary.</p> <p>Legacy defined benefit pension arrangements will continue to be honoured.</p>	None.
All-employee share plans			
To align interests of all employees with company share performance.	Executive Directors may participate in HMRC approved all-employee plans on the same basis as employees.	The maximum is as prescribed under the relevant HMRC legislation governing the plan.	None.

NOTES TO THE POLICY TABLE

A shareholding policy is also operated.

The Pennon Group Plc Committee reserves the right to make any remuneration payments and payments for loss of office (including exercising any discretions available to it in connection to such payments) that are not in line with the policy set out in this report where the terms of the payment were agreed before the policy came into effect or at a time when the relevant individual was not a Director and, in the opinion of the Committee, the payment was not in consideration for the individual becoming a Director of the company. For these purposes "payments" includes pension payments under legacy defined benefit pension plans and the satisfaction of awards of variable remuneration and, in relation to an award over shares, the terms of the payment are "agreed" at the time the award is granted.

The Performance and Co-Investment Plan (PCP) will be operated in accordance with the rules of the plan. In accordance with those rules the Committee has discretion in the following areas:

- awards can be granted as forfeitable shares, conditional share awards, nil or nominal cost options or awards in other forms it determines has a substantially similar purpose or effect. Awards may be settled in cash
- the Committee may adjust the number of shares under an award if there is a capitalisation, rights issue, subdivision, reduction or any other variation in the share capital, a demerger or special dividend, or any other exceptional event which in the opinion of the Committee justifies an adjustment;
- a performance condition applicable to a PCP award may be amended in accordance with its terms or if an event occurs which causes the Committee to consider that an amended performance condition would be appropriate (taking into account the interests of shareholders) and would be no less difficult to satisfy had the relevant event not executed;
- on a change of control or voluntary winding up of the Group, PCP awards may vest to the extent determined by the Committee having regard to the performance of the Pennon Group and the period of time that has elapsed since grant. Deferred bonus awards may vest early in full. Alternatively, participants may have the opportunity, or be required, to exchange their awards for equivalent awards in another company although the Committee may decide in these circumstances to amend the performance conditions; and
- the Committee has the discretion to treat a demerger, special dividend or other transaction that may affect the current or future value of awards as an early vesting event on the same basis as a change of control.

The Committee may make minor amendments to the policy (for example for regulatory, exchange control, tax or administrative purposes or to take account of a change in legislation) without obtaining Pennon shareholder approval for that amendment.

PERFORMANCE MEASURES AND TARGETS

The performance conditions for the annual incentive bonus plan are selected by the Committee to reflect the key performance indicators for the company and key metrics used by the Board to oversee the operation of the business. These targets are determined annually by the Committee following a review of the company forecasts and market expectations. Targets may be adjusted by the Committee to take account of events such as significant capital transactions.

In respect of the current long-term incentive plan performance conditions the Committee chose the two total shareholder return measures as it believes that performance against these measures aligns the Executive Director's interests with those of Pennon Group shareholders including how successful performance is compared to both the general market and a bespoke sector peer group.

DIFFERENCES IN REMUNERATION POLICY FOR ALL EMPLOYEES

All employees of the company are entitled to base salary, pension provision including life assurance. In addition all staff are entitled to participate in annual bonus arrangements, the levels of which are based on the seniority and responsibility of the role.

Other benefits such as car allowance and medical insurance are generally available only to more senior employees at management level and above and long-term incentive share awards are only available to senior executives and Directors. Generally, senior executives and directors receive a higher proportion of their total pay in the form of variable remuneration and share awards.

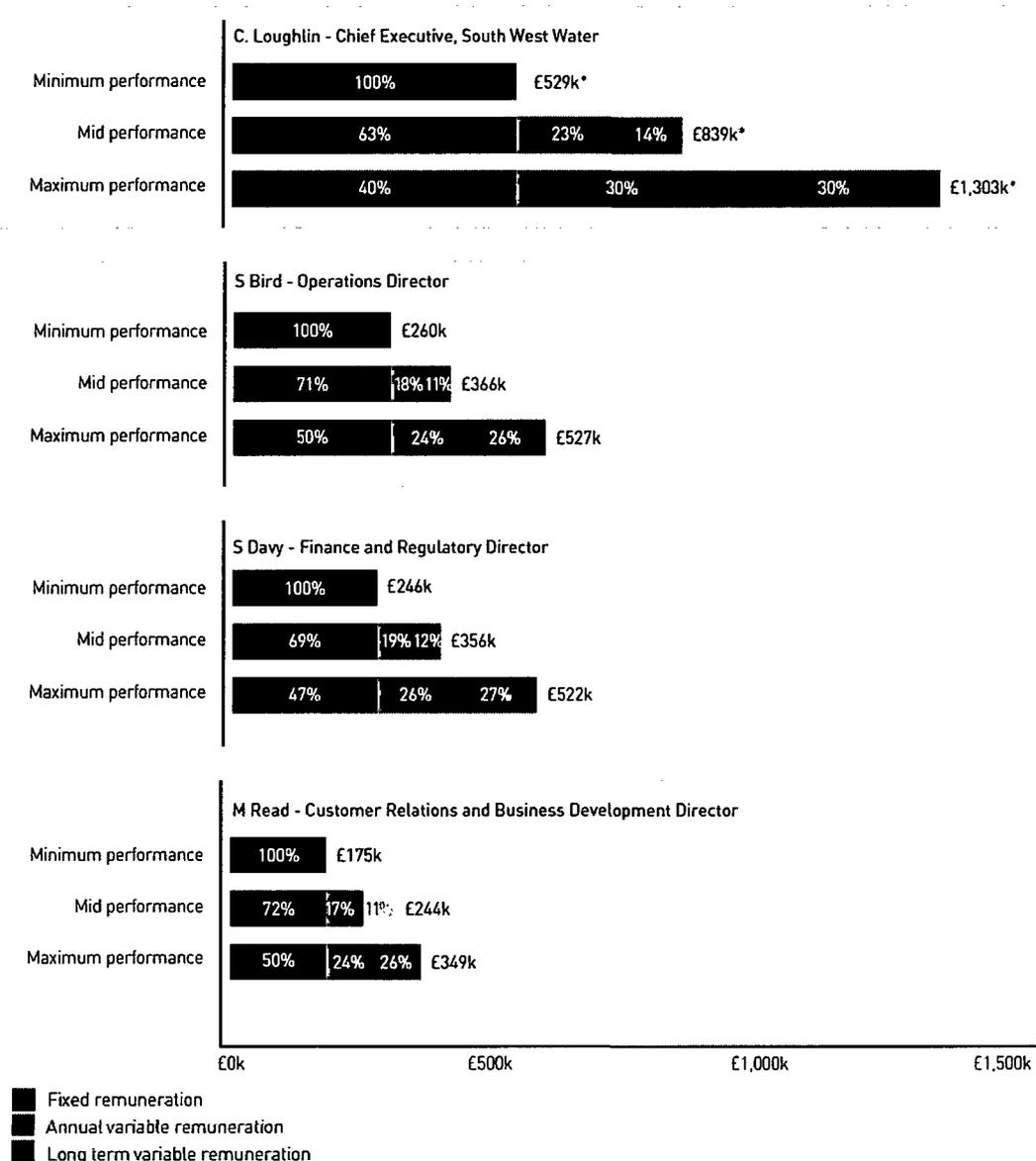
FUTURE POLICY TABLE – NON-EXECUTIVE DIRECTORS

The table below sets out the company's policy in respect of the setting of fees for Non-executive Directors.

How the components support the strategic objectives of the company	How the component operates	Maximum potential value of the component
Fees		
Set at a market level to attract Non-executive Directors who have appropriate experience and skills to assist in determining the company's strategy.	<p>Fees are set by the Board with the Chairman's fees being set by the Committee. The relevant Directors are not present at the meetings when their fees are being determined.</p> <p>Non-executive Directors normally receive a basic fee.</p> <p>In reviewing the fees the Board, or Committee as appropriate, consider the level of fees payable to Non-executive Directors in other companies of similar scale and complexity.</p>	Total fees paid to Non-executive Directors will remain within the limits stated by the Articles of Association.
Benefits		
Benefits for the Chairman are provided which are consistent with the market and level of seniority.	<p>Expenses incurred in the performance of Non-executive duties for the company may be reimbursed or paid for directly by the company (including any tax due on the expenses).</p> <p>The Chairman's benefits include the provision of a company vehicle, fuel and health insurance.</p>	None.

ILLUSTRATIONS OF APPLICATIONS OF REMUNERATION POLICY

The total remuneration for each of the Executive Directors that could result from the proposed remuneration policy in 2014/15 is shown below.



* 80% paid directly by South West Water

Scenario	Assumptions
Minimum performance	Fixed pay, which constitutes base salary, pension and benefits in kind. These values are made up of the salaries for 2014/15 (set out on page 59) and an estimate of the value of the benefits and pension
Mid performance	Fixed pay and 50% of the maximum annual bonus and 30% of the maximum long term incentive award.
Maximum	Fixed pay and 100% vesting of the annual bonus and long term incentive awards.

No adjustments have been made for potential share price growth or payment of dividends. Benefits from all-employee schemes have also been excluded.

APPROACH TO RECRUITMENT REMUNERATION

When considering the appointment of Executive Directors the Committee seeks to balance the need to offer remuneration to attract candidates of sufficient calibre to deliver the company's strategy whilst remaining mindful if the need to pay no more than is necessary.

Where possible, salaries may be set at an initially lower level with the intention of providing potential for higher than usual increases over the following two years to reflect experience gained and performance in the role. Other elements of remuneration would be in line with the company's policy set out in the table above.

The maximum variable pay opportunity on recruitment (excluding 'buyouts') would be in line with the future policy table on page 51 and 54. The Committee may determine for the first year of appointment that any annual bonus will be subject to different weightings or objectives.

To facilitate recruitment it may be necessary to recompense a new Executive Director for incentive rewards foregone with his previous employer ('buyout' awards). The Committee will ensure that any such award would at a maximum match the value of the awards granted by the previous employer and be made only where a director is able to demonstrate that a loss has been incurred from leaving his or her previous employment. Any buy out would take into account the terms of the arrangement forfeited, including in particular any performance conditions and the time over which they rest. The award would have time horizons which are in line with or greater than the awards forfeited.

For interim positions a cash supplement may be paid rather than salary (for example a Non-executive Director taking on an executive function on a short-term basis).

Where an employee is promoted to the position of Executive Director (including if an Executive Director is appointed following an acquisition or merger), pre-existing awards and contractual commitments would be honoured in accordance with their established terms.

Non-executive Directors fees would be in line with the policy set out on page 55.

DATES OF DIRECTORS' SERVICE CONTRACTS/LETTERS OF APPOINTMENT

The dates of Directors' service contracts and letters of appointment and details of the outstanding terms are shown below.

Executive Directors	Date of service contract	Expiry date of service contract
C Loughlin*	1 August 2006	No expiry date
S Bird*	1 March 2000	On normal retirement date at age 60 (14/05/2018)
S Davy*	31 August 2007	On normal retirement date at age 65 (17/05/2035)
M Read*	1 September 2002	On normal retirement date at age 60 (01/01/2022)

* Each Executive Director's service contract is subject to 12 months notice on either side.

Non-executive Directors	Date of letter of appointment	Expiry date of appointment
K Harvey	1 April 2005	Ongoing - subject to 12 months notice from either side
M Hagen	1 September 2010	31 August 2016
M Taylor	4 March 2010	29 February 2016

The policy is for Executive Directors' service contracts to provide for 12 months notice from either side. The policy is for Non-executive Directors' letters of appointment to contain three months notice period from either side and for the Chairman's letter of appointment to contain a 12 months' notice period from either side.

All Non-executive Directors were appointed for an initial three-year term. This is the second three-year term for M Hagen and M Taylor.

POLICY ON TERMINATION OF SERVICE AGREEMENTS AND PAYMENT FOR LOSS OF OFFICE

In the event that the employment of an Executive Director is terminated, any compensation payable will be determined by reference to the terms of the service contract between the company and the employee, as well as the rules of the various incentive plans as set out in the table below.

The company's policy is that Executive Directors' service agreements normally continue until the Director's agreed retirement date or such other date as the parties agree. Otherwise they are terminable on one year's notice and provide no entitlement to the payment of a predetermined amount on termination of employment in any circumstances.

There are no liquidated damages provisions for compensation on termination within Executive Directors' service agreements. Taking into account the circumstances of any termination the Committee may determine that a payment in lieu of notice should be made.

Any such payments would be restricted to salary and benefits. In these circumstances consideration would be given to phasing of payments and an individual's duty and opportunity to mitigate losses (for example stopping or reducing compensatory payments to former directors to the extent that they received remuneration from other employment during any compensation period).

The company may meet ancillary costs, such as outplacement consultancy and/or reasonable legal costs if the company terminates the Executive Director's service contract.

Annual bonus	<p>Normally no bonus is payable unless an Executive Director is employed on the date of payment.</p> <p>In certain good leaver circumstances (death, disability, normal retirement, redundancy and any other circumstance at the Committee's discretion) a bonus may be payable. Any such bonus would be based on performance and pro-rated to reflect the period of service with performance normally assessed at the same time as other employees. The Committee retains discretion to adjust the timing and pro-rating of any award to take account of any prevailing exceptional circumstances which they consider would be fair to the company and to the employee. Share deferral would not normally apply.</p>
Deferred shares	<p>Unvested awards would normally lapse upon cessation. In certain good leaver circumstances awards are released to participants on cessation of employment.</p> <p>Good leaver circumstances are death, disability, injury, ill-health, redundancy, retirement and any other circumstance at the Committee's discretion.</p>
Long-term incentive plan (Performance & Co-Investment Plan (PCP))	<p>Any unvested awards would normally lapse upon cessation of the individual's employment within the Group. In certain good leaver circumstances awards vest to the extent determined by the Committee taking into account the extent to which the performance target has been satisfied, the extent to which the co-investment condition has been satisfied, the period of time elapsed since grant and such other factors as the Committee may deem relevant. Awards would normally vest on the original normal vesting date unless the Committee determines awards should vest earlier.</p> <p>Good leaver circumstances are death, ill health, injury, disability, redundancy, retirement, the sale of the individual's employing company or business out of the Group and any other circumstance at the Committee's discretion.</p> <p>All awards would lapse if a participant was summarily dismissed.</p>
All-employee awards	Leavers will be treated in accordance with the HMRC approved rules.
Other awards	Where a buyout award is made on recruitment leaver provisions would be determined at the time of award.

STATEMENT OF CONSIDERATION OF EMPLOYMENT CONDITIONS ELSEWHERE IN THE COMPANY

In setting executive remuneration the Committee not only takes account of employment market conditions, but also of the pay and benefits differentials across the Pennon Group. The Committee considers annual summary reports of workforce remuneration and the terms and conditions of employment within the company and has regard to these in setting salary and other benefits for the Executive Directors and senior management, although these reports do not include comparison metrics.

The Committee does not consult with employees when drawing up the Directors' remuneration policy but does take account of the policy followed in the Pennon Group.

ANNUAL REPORT ON REMUNERATION

INTRODUCTION

This section sets out how the remuneration policy has been applied in the year and details of how the policy will be implemented for the year 2014/15.

OPERATION OF THE EXECUTIVE DIRECTOR REMUNERATION POLICY FOR 2014/15

During 2013 the Committee reviewed the incentive framework for Executive Directors. The key changes made were:

- adjustment of the corporate performance objectives for the annual bonus to ensure that they were aligned with the areas of challenge in the strategy
- as part of this review the Committee introduced malus and clawback arrangements in the annual bonus in accordance with best practice.

A summary of the specific remuneration arrangements for Executive Directors in 2014/15 are described below:

Base salary	Salary increases of between 2.5% and 5%, effective 1 April 2014. 2014/15 salaries are: - C Loughlin: £387,000 ⁴ - S Bird: £172,300 - S Davy: £178,600 - M Read: £112,000 ⁵
Pension and benefits	No changes. Defined contribution pension or salary supplement cash allowance of between 16% and 30%.
Annual bonus	No change to maximum opportunity of: C Loughlin: 100% ⁴ of salary S Bird, S Davy and M Read: 75% of salary No change to operation of deferral. 50% of the bonus is delivered as deferred shares. Following a review of the performance measures, annual bonus will be based on the following for 2014/15: C Loughlin ⁴ : - 30% ⁴ Pennon Group EPS performance - 30% ⁴ personal strategic objectives - 40% ⁴ measures specific South West Water including net debt, SWW operating profit, SIM performance and serviceability S Bird, S Davy and M Read: - 25% South West Water operating profit - 10% net debt - 15% operational specific measures SIM performance and serviceability

⁴ 80% of this remuneration is paid by South West Water

⁵ pro-rated for part-time service

	<p>- 25% personal strategic objectives More detail on the measures and weightings is provided on the following page. The objective was to ensure alignment to measures identified as key for each role with an appropriate balance between hard financial measures and objectives aligned to the strategic success of the business.</p> <p>For bonuses from 2014/15 both malus and clawback will apply as described in the Remuneration Policy Report.</p>
Long-term incentive plan (Performance & Co-Investment Plan (PCP))	<p>No changes. Awards of 100%⁶ of base salary for C Loughlin and 80% for S Bird, S Davy and M Read. Awards subject to co-investment Performance measures: - 50% TSR vs FTSE 250 (excluding investment trusts) - 50% TSR vs a Water/Waste peer group index. "Underpin" relating to overall Group performance. Actual vesting may differ from award received.</p>
Shareholding guidelines	<p>No change. 100% of salary to be built up in the first five years of joining.</p>

FORWARD-LOOKING PERFORMANCE TARGETS

Details of the annual bonus framework that will apply for each Executive Director for 2014/15 are set out in the table below:

C Loughlin

	Maximum % of salary
Pennon Group Plc EPS ¹²	30%
Average South West Water Directors' performance ² :	40%
1. operating profit	
2. SIM performance	
3. Serviceability	
4. Net debt	
Personal ²	30%

¹ Pennon Group Plc EPS is before deferred tax and exceptional net charges

² 80% paid directly by South West Water

S Bird, S Davy and M Read

	Maximum % of salary
South West Water performance:	50%
1. operating profit	
2. SIM performance	
3. Serviceability	
4. Net debt	
Personal	25%

The specific bonus targets are considered to be commercially sensitive. However the Committee intends to disclose details of the target set retrospectively to the extent they are not considered commercially sensitive.

⁶ 80% of this remuneration is paid by South West Water

For PCP (long-term incentive plan) the targets are set out below:

	Threshold (30% of maximum vests)	Maximum (100% of maximum vests)
Water/Waste Index (50% of award)	Equal to index	15% above the index
FTSE 250 (excluding investment trusts) (50% of award)	Above 50 th percentile	At or above 75 th percentile

The waste/water index will comprise:

- Shanks Group
- Seche Environment
- Suez Environment
- Severn Trent
- National Grid
- United Utilities
- Veolia Environment

SINGLE TOTAL FIGURE OF REMUNERATION TABLES

	Base salary / fees (£000)		All taxable benefits (£000)		Annual performance cash bonus (£000)		Annual performance deferred shares		Long-term performance related remuneration (£000)		Pension related benefits (£000)		Total Year to 31 March (£000)	
	2013/14	2012/13	2013/14	2012/13	2013/14	2012/13	2013/14	2012/13	2013/14	2012/13	2013/14	2012/13	2013/14	2012/13
Executive Directors														
C Loughlin*, Chief Executive	302	296	24	20	128	94	128	94	109	193	90	89	781	786
S Bird, Operations Director	168	164	15	14	53	49	53	49	47	83	72	80	408	439
S Davy, Finance & Regulatory Director	174	170	13	12	62	52	62	52	49	77	54	53	414	416
M Read^, Customer Relations & Business Development Director	107	104	22	22	34	31	34	31	31	54	41	21	269	263
Non-executive Directors														
K Harvey*, Chairman	128	124	13	12	-	-	-	-	-	-	-	-	141	136
M Hagen, Non-executive Director	35	35	-	-	-	-	-	-	-	-	-	-	35	35
M Taylor, Non-executive Director	35	35	-	-	-	-	-	-	-	-	-	-	35	35

NOTES TO THE SINGLE TOTAL FIGURE REMUNERATION TABLE

* C Loughlin is an Executive Director of Pennon Group Plc as well as Chief Executive of South West Water. The disclosures above reflect 80% of his full which is paid directly by South West Water.

* K Harvey is the Chairman of Pennon Group Plc and South West Water. The disclosures above reflect 50% of his full remuneration which is chargeable to South West Water through Group recharges.

^ pro-rated for part-time service

Base salary

Executive Director C Loughlin, received a 2% increase in basic salary for 2013/14. Other Executive Directors received 2.5%.

Benefits

Benefits include private health insurance and use of a company car.

Pension

The pension related benefits reflect the employer defined benefit contribution arrangements and payment of cash in lieu of pension benefit.

ANNUAL BONUS OUTTURN FOR 2013/14

The annual bonus for South West Water Directors were approved by the Remuneration Committee of Pennon Group Plc on 12 June 2014. For 2013/14 no Director achieved the maximum bonus available. The actual performance against each area is shown in the table below.

C Loughlin

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
Pennon Group Plc EPS ⁷	40%	35.9p	39.8p	45.8p	42.6p	27.1%
South West Water performance ¹⁰	40%	The average of the bonus earned by the other Executive Directors of South West Water which relate to: <ul style="list-style-type: none">• out-performance against operating costs;• profit before tax, capital expenditure and net debt targets of the company;• the position the company achieves in the 'Service Incentive Mechanism' of water and sewerage companies established by Ofwat;• the achievement of a range of service standards set for the company by Ofwat; and• personal objectives relating to key initiatives, projects and compliance targets for South West Water.* SWW PBT targets were £138 million to £160 million and were exceeded. Actual SWW PBT performance was £162.5 million. In considering the outcome for this element the Committee exercised discretion in relation to the excellent performance in achieving 'enhanced status' for the SWW business plan with Ofwat.				40%
Personal objectives ¹⁰	20%	Implementing South West Waters new strategies and projects and meeting compliance targets.*			-	18%
Total ¹⁰	100%					85.1%

* Actual targets considered commercially confidential

⁷ EPS is before deferred tax and exceptional net charges

⁸ 80% is paid by South West Water

S Bird, S Davy, M Read

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
South West Water performance	55%	Bonus earned by Executive Directors of South West Water relate to: <ul style="list-style-type: none"> • out-performance against operating costs; • profit before tax, capital expenditure and net debt targets of the company • the position the company achieves in the 'Service Incentive Mechanism' of water and sewerage companies established by Ofwat • the achievement of a range of service standards set for the company by Ofwat SWW PBT targets were £138 million to £160 million and were exceeded. Actual SWW PBT performance was £162.5 million. In considering the outcome for this element the Committee exercised discretion in relation to the excellent performance in achieving 'enhanced status' for the SWW business plan with Ofwat.				S Bird 45.625% S Davy 53.125% M Read 45.625%
Personal objectives	20%	Implementing South West Water's new strategies and projects and meeting compliance targets*			-	18%
Total	75%	S Bird S Davy M Read				63.625% 71.125% 63.625%

* Actual targets considered commercially confidential

PERFORMANCE & CO-INVESTMENT PLAN OUTTURN FOR 2013/14

The PCP award included in the single figure table relates to the awards made on 1 July 2011, which are due to vest on 30 June 2014.

50% of the awards will vest subject to the Pennon Group's TSR performance measured against an index made up of the following six listed water and waste comparator companies. These companies were considered to be the Group's key listed comparators:

- Northumbrian Water Group
- Shanks Group
- Séché Environnement
- Suez Environnement
- Severn Trent
- United Utilities

Northumbrian Water Group delisted from the London Stock Exchange in October 2011. The Committee therefore decided to include this company in the calculation of the index up to the date of delisting and exclude the company from the date of delisting.

The remaining 50% of the awards will vest subject to the Group's ranked TSR performance against the constituents of the FTSE 250 (excluding investment trusts).

The calculation of TSR performance over the three year performance period (being 1 April 2011 to 1 April 2014) for the PCP awards was undertaken by Deloitte LLP for the Committee.

Vesting of the award is according to the following schedule:

	Threshold (30% of maximum vests)	Maximum (100% of maximum vests)	Achievement in the period to 1 April 2014*	Outturn*
Water/Waste Index (50% of award)	Equal to index	15% above the index	6.5% out performance	30.2%
FTSE 250 (excluding investment trusts) (50% of award)	Above 50th Percentile	At or above 75th Percentile	36.5%	0%

Straight line vesting between points. For below threshold performance, 0% vests

* The calculation requires averaging TSR performance over the first three months of the performance period and comparing it to the average over the three months following the end of the performance period (1 April 2014 to 30 June 2014).

Vesting of the award is also subject to the "Underpin" described on page 53 which the Pennon Group Remuneration Committee has determined to the date of this report would be satisfied.

PENSION

S Bird, S Davy and M Read were members of the Pennon Group's defined benefit pension arrangements during the year. The value of pension benefits accrued in the year has been included in the single total figure table of page 61.

Total pension entitlements for each director is shown in the table below:

	Defined benefit pension accrued at 31 March 2014 £000 per annum	Normal retirement age	Description of additional benefits available to the director on early retirement
S Bird	88	60	None
S Davy	12	65	None
M Read	58	60	None

The accrued pension is based on service to the year end and final pensionable salary at that date, or where the Director has left the scheme, determined at the Director's date of leaving the scheme.

S Davy is entitled to normal retirement pension payable from age 65 of broadly 1/80th of pensionable remuneration for each year of pensionable service completed. S Bird and M Read are entitled to a normal retirement pension payable from age 60 of broadly 2/3rds of pensionable pay, adjusted as appropriate for periods of part-time service.

OUTSIDE APPOINTMENTS

Executive Directors may accept one board appointment in another company. Board approval must be sought before accepting the appointments. Fees may be retained by the director. Currently, no Executive Directors hold outside company appointments (other than with industry bodies, governmental or quasi governmental agencies, educational, or charitable institutions).

ALL EMPLOYEE, PERFORMANCE AND OTHER CONTEXTUAL INFORMATION

Remuneration of the Chief Executive (CE)

	2009/10	2010/11	2011/12	2012/13	2013/14
CE single figure of remuneration (£000) ⁹	758	984	834	786	781
Annual bonus payout (% of maximum)	91.4%	93.1%	86.8%	63.6%	85.1%
LTIP (PCP) vesting (% of maximum)	67.3%	50.0%	79.3%	50.0%	30.2%

Comparison of the Chief Executive Director's remuneration to employee remuneration

The table below shows the percentage change between 2012/13 and 2013/14 in base salary, benefits and annual bonus for the Chief Executive Director and all employees.

The percentage increase in average remuneration for employees is calculated using wages and salaries (excluding sharebased payments and national insurance) of £44.8m (2012/13 £43.2m), analysed into the three components in the table and the average number of employees of 1,169 (2012/13 1,163) (both as detailed in note 11 to the financial statements).

	Percentage change in salary	Percentage change in benefits	Percentage change in annual cash bonus
CEO Remuneration	2.0%	0%	36%
All employees	2.5%	0%	15%

RELATIVE IMPORTANCE OF SPEND ON PAY

	2013/14 £m	2012/13 £m	Percentage change
Overall expenditure on pay ¹⁰	46.1	44.4	+3.8%
Distributions to Parent Company	112.0	133.0	-15.8%
Net Interest charges	64.5	68.2	-5.4%
Purchase of property, plant and equipment (cash flow)	146.5	111.9	+30.9%

The above table illustrates the relative importance of spend on pay compared with other disbursements from profit and outgoings. The purchase of property, plant and equipment (cash flow) has been included as these were the most significant outgoings for the company in the last financial year.

SHARE AWARDS GRANTED DURING 2013/14

The table below sets out details of share awards made in the year to Executive Directors.

Executive Director	Type of interest	Basis of award	Face value £000	Percentage vesting at threshold performance	Performance period end date
C Loughlin	PCP	100% of salary	377 ¹¹	30% of maximum	31 March 2016
S Bird			134		
S Davy		139			
M Read		80% of salary	85		

⁹ Amount reflects 80% of award chargeable to South West Water

¹⁰ Excludes employer's social security costs

¹¹ 80% is chargeable to South West Water

Executive Director	Type of interest	Basis of award	Face value £000	Percentage vesting at threshold performance	Performance period end date
C Loughlin	Deferred bonus / ESOS	50% of bonus awarded	118 ¹³	n/a	4 August 2016
S Bird			49		
S Davy			52		
M Read			31		

PCP awards were calculated using the share price at the date of grant (2 July 2013) which was £6.53 per share. Deferred bonus awards were calculated using the share price at the date of grant (5 August 2013) which was £6.93.

The deferred bonus plan is operated in conjunction with the Pennon Group's HMRC approved share option scheme (ESOS). This is on the basis that the aggregate pre-tax value of the awards made under both the annual bonus and the ESOS would be the same as they would have been if the bonus plan had operated alone. This is achieved by requiring that an amount of deferred shares, equal in value to any gain made on the exercise of ESOS options, is forfeited by the directors at the end of the 3 year deferral period.

SHARE AWARD AND SHAREHOLDING DISCLOSURES

DIRECTORS' SHAREHOLDING AND INTERESTS IN SHARES

The Remuneration Committee believes that the interests of Executive Directors and senior management should be closely aligned with shareholders. To support this the Committee operates a shareholding guidelines. The Executive Directors are expected to build up a shareholding in Pennon Group Plc in accordance with the shareholding guideline which amounts to a shareholding interest equivalent to 100% of salary to be built up within the first five years of joining the company.

	Share interests (including connected parties) at 31 March 2014	Share interests (including connected parties) at 31 March 2013	Share-holding guideline	Share-holding guideline met?	Performance shares (subject to performance conditions)	Unvested awards			
						SAYE	Deferred Bonus shares	ESOS	Share Incentive Plan
C Loughlin	193,543	150,766	100%	Yes	157,387	2,788	59,769	4,329	–
S Bird	20,058	21,145	100%	Yes	55,316	1,113	20,682	4,329	–
S Davy	30,085	28,584	100%	Yes	57,381	1,530	20,896	4,329	1,702
M Read	55,711	60,840	100%	Yes	35,392	3,850	13,224	4,329	2,296

* Since 31 March 2014, 3,512 additional Ordinary shares in the Company have been acquired by Chris Loughlin as a result of participation in the Company's Scrip Dividend Alternative and the Company's Share Incentive Plan. There have been no other changes in the beneficial interests or the non-beneficial interests of the Directors in the Ordinary shares of Pennon Group Plc between 1 April 2014 and 8 July 2014.

NON-EXECUTIVE DIRECTORS' SHAREHOLDING

The beneficial interests of the Non-executive Directors, including the beneficial interests of their spouses, civil partners, children and step-children, in the ordinary shares (40.7p) of Pennon Group Plc, are shown in the table below:

Director	Shares held at 31 March 2014	Shares held at 31 March 2013
K Harvey	26,209	26,209
M Hagen	3,600	3,600
M Taylor	-	-

DETAILS OF SHARE AWARDS

(a) Performance of co-investment plan (long-term incentive plan)

In addition to the above beneficial interests, the following Directors have or had a contingent interest in the number of Ordinary shares (40.7p each) of Pennon Group Plc shown below, representing the maximum number of shares to which they would become entitled under the plan should the relevant criteria be met in full:

Director and date of award	Conditional awards held at 1 April 2013	Conditional awards made in year	Market price upon award in year	Vesting in year	Value of shares upon vesting (before tax) £000	Conditional awards held at 31 March 2014	Date of end of period for qualifying conditions to be fulfilled
C Loughlin							
2/7/10	63,186	-	546.00p	35,194	241	-	1/7/13
1/7/11	51,432	-	698.00p	-	-	51,432	30/6/14
3/7/12	48,145	-	768.50p	-	-	48,145	2/7/15
2/7/13	-	57,810	653.00p	-	-	57,810	1/7/16
S Bird							
2/7/10	21,684	-	546.00p	12,077	83	-	1/7/13
1/7/11	17,650	-	698.00p	-	-	17,650	30/6/14
3/7/12	17,072	-	768.50p	-	-	17,072	2/7/15
2/7/13	-	20,594	653.00p	-	-	20,594	1/7/16
S Davy							
2/7/10	20,146	-	546.00p	11,221	77	-	1/7/13
1/7/11	18,338	-	698.00p	-	-	18,338	30/6/14
3/7/12	17,696	-	768.50p	-	-	17,696	2/7/15
2/7/13	-	21,347	653.00p	-	-	21,347	1/7/16
M Read							
2/7/10	14,147	-	546.00p	7,879	54	-	1/7/13
1/7/11	11,507	-	698.00p	-	-	11,507	30/6/14
3/7/12	10,826	-	768.50p	-	-	10,826	2/7/15
2/7/13	-	13,059	653.00p	-	-	13,059	1/7/16

*50% of the July 2010 award shares vested on 8 August 2013 at a market price of 683.55p per share. The total number of shares that vested included additional shares equivalent in value to such number of shares as could have been acquired by reinvesting the dividends which would otherwise have been received on the vested shares during the restricted period of three years. The balance of the award lapsed.

(b) Annual incentive bonus plan – deferred bonus shares (long-term incentive element)

The following Directors had or have a contingent interest in the number of ordinary shares (40.7p each) of the Pennon Group Plc shown below, representing the total number of shares to which they have or would become entitled under the deferred bonus element of the annual incentive bonus plan (the bonus plan) at the end of the relevant qualifying period:

Director and date of award	Conditional awards held at 1 April 2013	Conditional awards made in year	Market price upon award in year	Vesting in year	Value of shares upon vesting (before tax) £000	Conditional awards held at 31 March 2014	Date of end of period for qualifying conditions to be fulfilled
C Loughlin							
27/2/10	1,261	-	524.50p	1,261 ¹⁴	9	-	26/2/13
27/7/10	25,133	-	572.50p	25,133 ¹²	177	-	26/7/13
27/7/11	22,141	-	725.00p	-	-	22,141	26/7/14
27/7/12	20,650	-	754.50p	-	-	20,650	26/7/15
5/8/13 ¹³	-	16,978	693.00p	-	-	16,978	4/8/16
S Bird							
27/2/10	1,079	-	524.50p	1,079 ¹⁴	8	-	26/2/13
27/7/10	7,548	-	572.50p	7,548 ¹⁴	53	-	26/7/13
27/7/11	6,681	-	725.00p	-	-	6,681	26/7/14
27/7/12	6,949	-	754.50p	-	-	6,949	26/7/15
5/8/13 ¹⁵	-	7,052	693.00p	-	-	7,052	4/8/16
S Davy							
27/2/10	884	-	524.50p	884 ¹⁴	6	-	26/2/13
27/7/10	6,558	-	572.50p	6,558 ¹⁴	46	-	26/7/13
27/7/11	6,078	-	725.00p	-	-	6,078	26/7/14
27/7/12	7,263	-	754.50p	-	-	7,263	26/7/15
5/8/13 ¹⁵	-	7,555	693.00p	-	-	7,555	4/8/16
M Read							
27/2/10	704	-	524.50p	704 ¹⁴	5	-	26/2/13
27/7/10	4,444	-	572.50p	4,444 ¹⁴	31	-	26/7/13
27/7/11	4,261	-	725.00p	-	-	4,261	26/7/14
27/7/12	4,491	-	754.50p	-	-	4,491	26/7/15
5/8/13 ¹⁵	-	4,472	693.00p	-	-	4,472	4/8/16

C Loughlin also received ordinary shares (40.7p each) in Pennon Group Plc as a result of participation in the Group's scrip dividend alternative and these shares are included in the figure given for the additional Ordinary shares (40.7p each) in the Pennon Group Plc that he acquired since 31 March 2014.

A further conditional award of shares will be made in 2014/15 to the value of the amount of the performance-related cash bonus shown in the emoluments of directors table on page 61. Page 52 sets out the provisions relating to the conditional award of shares pursuant to the bonus plan.

¹² These shares vested on 2 August 2013 at £7.052 per share

¹³ In addition to the awards made on 5 August 2013 the Directors also received options pursuant to the Pennon Group's executive share option scheme (the ESOS), details of which are set out on page 101. These awards were made in conjunction with the operation of the bonus plan.

(c) Executive Share Option Scheme (ESOS)

The following directors had a contingent interest in the number of options in the ordinary shares (40.7p each) of Pennon Group Plc pursuant to the group's executive share option scheme.

Award	Options held at 1 April 2013	Granted in year	Exercised in year	Exercise price per share	Market price of each share on exercising	Market value of each share at 31 March 2014	Options held at 31 March 2014	Maturity date
C Loughlin								
5/8/13	-	4,329	-	693.00p	-	742.50p	4,329	5/8/16
S Bird								
5/8/13	-	4,329	-	693.00p	-	742.50p	4,329	5/8/16
S Davy								
27/7/10	367	-	367	572.50p	681.50p	-	-	-
5/8/13	-	4,329	-	693.00p	-	742.50p	4,329	5/8/16
M Read								
27/7/10	1,528	-	1,528	572.50p	681.50p	-	-	-
5/8/13	-	4,329	-	693.00p	-	742.50p	4,329	5/8/16

(d) Sharesave scheme

Details of options to subscribe for ordinary shares (40.7p each) of Pennon Group Plc under the all-employee sharesave scheme were:

Director and date of grant	Options held at 1 April 2013	Granted in year	Exercised in year	Exercise price per share	Market price of each share on exercising	Market value of each share at 31 March 2014	Options held at 31 March 2014	Exercise period/ maturity date
C Loughlin								
3/7/13	-	2,788	-	538.00p	-	742.50p	2,788	1/9/18 – 28/2/19
S Bird								
29/6/12	612	-	-	588.00p	-	742.50p	612	1/9/15 – 28/2/16
3/7/13	-	501	-	538.00p	-	742.50p	501	1/9/16 – 28/2/1
S Davy								
29/6/12	1,530	-	-	588.00p	-	742.50p	1,530	1/9/15 – 28/2/16
M Read								
6/7/09	2,417	-	-	386.00p	-	742.50p	2,417	1/9/14 – 28/2/15
28/6/10	1,433	-	-	431.00p	-	742.50p	1,433	1/9/15 – 28/2/16

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.

How we manage risk

We operate a well established and fully embedded risk management process from which we seek to identify significant risks at the earliest possible stage and determine whether they are acceptable risks which we can manage and mitigate satisfactorily. More detail on our risk management process is set out on page 45.

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

RISK	COMMENTARY	MITIGATION
Regulatory		
Uncertainty arising from Regulatory Reform ↓	<p>2012/13 has seen the modification of company Licences in preparation for the next price review and a number of methodology change proposals.</p> <p>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.</p>	<p>South West Water's PR14 business plan aligned with the changes in the regulatory framework and was assessed as enhanced. The Draft Determination for 2015-20 has already been received and allows the company to begin to implement the strategy for K6 earlier than may otherwise be possible.</p> <p>South West Water continues to contribute fully to consultations from all our Regulators and seeks to influence emerging changes through strong relationships with our stakeholders.</p>
Legislative & regulatory compliance ↔	<p>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.</p>	<p>Performance against key regulatory outputs are reported to the Board on a monthly basis and where performance falls short, corrective programmes are developed and implemented to target recovery in a specific area.</p> <p>There are a number of internal monitoring and assurance programmes which are undertaken throughout the year and annual data is supported by external verification through the company financial and technical auditors to provide assurance on the company's compliance with its obligations.</p>

Economic conditions		
<p>Non-recovery of customer debt & affordability</p> <p style="text-align: center;"></p>	<p>Customer debt and affordability are key areas of focus given the continued challenging economic conditions. It has been identified that within South West Water's region, the level of deprivation is above the average for the country.</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"> • use of third party collection agencies • external trace data to track down previous occupiers • continued use of property charging orders. <p>The company has also continued to fund and promote ways to help customers struggling to pay bills (WaterCare, Restart, FreshStart 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 our WaterCare tariff from 2013/14. During the year 1,100 customers have benefited from reducing bills to an amount they can better afford to pay.</p> <p>The Government Payment reducing household customer bills by £50 per year has been effectively implemented and administered during the year, with eligible households benefiting from the reduction.</p> <p>In future, changes to benefits and universal credits (particularly the impact of the 'bedroom tax' and limiting the total level of benefits available) may further affect the ability of customers to pay their bills.</p>

Finance and funding		
<p>Company may be unable to raise sufficient funds to finance its activities or such funds may be only available at higher cost.</p> <p style="text-align: center;"></p>	<p>The company can be impacted by wider economic conditions and availability of finance from banks and other institutions.</p>	<p>South West Water has 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 has access to 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 and ensuring pre-funding is available into the next regulatory period (2015-20).</p>
<p>The company does not deliver its financial targets</p> <p style="text-align: center;"></p>	<p>There are number of areas which would impact the delivery of South West Water's financial targets including:</p> <ul style="list-style-type: none"> • Revenue – impacted by customer demand and other income streams • Operating costs – through cost pressures and not delivering the required efficiencies • Capital costs – through pricing pressures and challenging output delivery. <p>In line with its track record, South West Water remains confident of delivering the assumed operating cost savings and has a track record of delivering its capital programme in accordance with regulatory requirements.</p> <p>Progress is regularly monitored and reviewed. Obligations which arise within a price control period such as Private Sewers and Revised Bathing Water Guidance have been included within our 2015-20 business plan and other obligations could be funded through future adjustments to price limits if they arise.</p>	<p>The financial impact of changes in customer demand is mitigated through the Regulatory Revenue Correction Mechanism, whereby shortfalls in revenue in one five year regulatory pricing period are adjusted in the following period.</p> <p>Whilst the downturn in economic activity in recent years has impacted South West Water's other income streams, 2013/14 has seen an increase in activity particularly those related to the property market (new connections, searches and other developer activity).</p> <p>The company has delivered cumulative operating cost efficiencies ahead of K5 targets and is on track to deliver targeted capital efficiencies.</p> <p>In addition, South West Water has committed to deliver improved bathing water compliance by 2015 and as a result are investing c.£18m in improving 7 sites which directly impact the quality of bathing water.</p> <p>SWW continue to manage all cost pressures as they arise in addition to achieving operating cost efficiencies and managing inflationary increases.</p>

<p>Pension costs may increase and investment performance may increase the net pension scheme deficit</p> <p style="text-align: center;">↓</p>	<p>All defined benefit schemes have been closed to new entrants and replaced by defined contribution arrangements. In addition, South West Water has concluded a consultation with Employees which will see the defined benefit pension scheme being restructured.</p>	<p>Changes have been implemented to the defined benefit scheme rules which will reduce and mitigate ongoing pension risk from July 2014.</p>
<p>Operating Performance</p>		
<p>Non-compliance or avoidable H&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.</p>	<p>There are rigorous health and safety policies and procedures in place across South West Water.</p> <p>Senior management and Executive visits are completed during the year across a number of sites and in addition the behavioural safety programme launched in 2012 badged 'TAP' has continued to be publicised.</p> <p>The number of accidents reportable under RIDDOR (Reporting for Injuries, Diseases and Dangerous Occurrences Regulations) for 2013 continued to fall with 3¹ incidents reported in the year compared to 7 in 2012.</p> <p>South West Water continually reviews health and safety standards and make improvements as necessary to best working practice. Continuous training is being provided to ensure that appropriate health and safety working practises are embedded and the accident review panel continues to complete thorough investigations of root causes and ensure a consistent approach to RIDDOR management is adopted.</p> <p>¹ This does not include the tragic death of a wastewater team member at one of our sites.</p>
<p>Significant operational failure or incident occurs</p> <p style="text-align: center;">↔</p>	<p>Due to the nature of South West Water's business there are continued risks rising 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. This could include:</p>	<p>South West Water has established procedures and controls in place, as well as contingency plans and incident management procedures.</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</p>

	<ul style="list-style-type: none"> • contamination of water supplies • pollution and flooding events • water resource restrictions <p>South West Water is committed to minimising the impact on the environment.</p> <p>The extreme wet weather during the latter part of the year has resulted in higher number of flooding incidents than a 'normal year', however the number has reduced from 2012/13. This has also impacted the number of pollution incidents recorded in the year.</p>	<p>water efficiency measures.</p> <p>South West Water also considers the longer term resource situation and prepares a new Water Resources Management Plan every five years and reviews it annually for a range of climate change and demand scenarios.</p> <p>In recent years, South West Water has worked in partnership with other representatives to identify the wide range of factors that can cause and exacerbate flooding events.</p> <p>The company has identified targeted capital investments to reduce the risk to specific customers in key affected areas and working alongside local flood authorities, other partner agencies, developers and environmental groups are identifying best practice management of extreme rainfall and flooding.</p>
<p>Extreme weather and climate change</p> <p style="text-align: center;"></p>	<p>2013/14 has again seen a range of extreme weather which has challenged operations.</p> <p>The summer heat wave placed pressure on maintaining supplies to customers, particularly with the increase in tourism, [whilst the winter of 2013 was the wettest on record for England]. The combination of storm surges, high winds, extreme rainfall and fluvial flooding has placed significant challenges on South West Water's operations and in particular those assets that rely on coastal defences.</p>	<p>Despite this weather, service to customers has been maintained and the business is and has been well placed to manage such extreme incidents. A key mitigation is having detailed contingency plans, sufficient emergency resources and a capital programme that supports ongoing efforts to manage these risks.</p> <p>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 anticipated hotter, drier summers and wetter winters which are anticipated.</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 quality of our customer service is also of interest to a number of key stakeholders and we work effectively with them to maintain confidence and trust in the services we provide.</p>	<p>The company has delivered further improvements in customer service with a further increase in the Service Improvement Mechanism (SIM) score and our best ever score in the last quarter of 2013/14.</p> <p>Since the beginning of K5 (2010-15) written complaints have halved and our SIM score has almost doubled.</p>
	<p>South West Water could incur a financial</p>	<p>South West Water continues to target</p>

	penalty under Ofwat's Service Incentive Mechanism (SIM) for below average customer service performance.	improvements in customer service and satisfaction.
Market		
<p>Uncertainty arising from market reform</p> <p style="text-align: center;"></p>	<p>Whilst the Water Act recognises an approach to reform that is '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. With the introduction of retail competition from 2017, SWW is fully engaged in Defra's 'Open Water' project which is managing the development of the central market.</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> <p>In addition, South West Water is participating in discussions for the design of Upstream reform.</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 loss of key stakeholder support could impact the delivery of South West Water's activities.</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>

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.

DIRECTORS' REPORT – OTHER STATUTORY INFORMATION

Introduction

This Directors' report is prepared in accordance with the provisions of the Companies Act 2006 and regulations made thereunder. It comprises the following two pages and the following matters disclosed elsewhere in this Annual Report as follows:

- List of directors during the year as set out on page 35 and 36
- risk management objectives and policies (page 45)
- likely future developments of the company (outlook sections of the strategic report)
- inclusion and gender diversity (page 46 of the corporate governance report)
- carbon emissions (see page 19)
- directors' responsibilities statements (page 81)
- financial instruments (note 14 of the financial statements).

Financial results and dividend

A total dividend for the year of £112.0m was paid during the year. The 'Finance and Economy' section of the Strategic report on pages 22 to 26 analyses the Company's financial results in more detail and sets out other financial information.

Directors

No Director has, or has had, a material interest, directly or indirectly, at any time during the year under review in any contract significant to the company's business.

A list of all the Directors during the year is set out on page 35 and 36. Further details relating to the Directors and their service agreements or contracts for services are set out on page 57 and details of the Directors' interests in shares of Pennon Group Plc are given on pages 66 to 69.

Directors' insurance and indemnities

The directors have the benefit of the indemnity provisions contained in the company's Articles and the company has maintained throughout the year Directors' and Officers' liability insurance for the benefit of the company, the Directors and its Officers. The company has entered into qualifying third party

indemnity arrangements for the benefit of all its Directors in a form and scope which comply with the requirements of the Companies Act 2006 and which were in force throughout the year and remain in force.

Statement as to disclosure of information to auditors

- a) So far as each of the Directors in office at the date of the signing of the report is aware, there is no relevant audit information of which the Company's auditors are unaware; and
- b) each of the Directors has taken all the steps each Director ought to have taken individually as a Director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Employee policies and assistance

South West Water is an equal opportunities employer and we recognise the importance and benefits of a diverse workforce. South West Water's employment policies are non-discriminatory and we make every effort to ensure that no current or future employee is disadvantaged because of age, gender, religion, ethnic origin, marital status, sexual orientation or disability.

Furthermore, we support our employees through a range of 'family-friendly' policies and other benefits. These include salary sacrifice schemes (e.g. for childcare) and our FirstCare absence reporting system.

All employees are also entitled to participate in the Pennon Group ShareSave Scheme and the Pennon Group Share Incentive Plan, both of which are all-employee plans (for which performance conditions do not apply).

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.

- **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.

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. Trade creditors at 31 March 2014 represented 20 days of the amount invoiced by suppliers during the year (2013: 27).

Political donations

No political donations were made or political expenditure incurred and no contributions were made to a non-EU political party. (2012/13: nil).

Incidents and prosecutions

In 2013/14 the company was the subject of 7 prosecution cases brought by the Environment Agency. These cases resulted in South West Water being convicted of 12 offences with a total fine of £134,000.

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.

Annual General Meeting

The twenty-fourth Annual General Meeting of South West Water Limited will be held at Peninsula House, Rydon Lane, Exeter on 1 August 2014 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 2014.

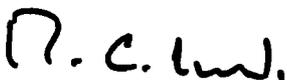
Resolution 2

To appoint Ernst & Young as auditors of the Company to hold office until the conclusion of the next general meeting at which the Financial Statements 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



R C Zmuda
Secretary
Peninsula House
Rydon Lane
Exeter
Devon
EX2 7HR

8 July 2014

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 R C Zmuda M L Heeley
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 IN RESPECT OF THE ANNUAL REPORT AND THE FINANCIAL STATEMENTS

The Directors are responsible for preparing the strategic report, a 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.

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

Report on the financial statements

Our opinion

In our opinion the financial statements, defined below:

- give a true and fair view of the state of the company's affairs as at 31 March 2014 and of its profit and cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union;
- and have been prepared in accordance with the requirements of the Companies Act 2006.

This opinion is to be read in the context of what we say in the remainder of this report.

What we have audited

The financial statements, which are prepared by South West Water Limited, comprise:

- the balance sheet as at 31 March 2014;
- the income statement and statement of comprehensive income for the year then ended;
- the cash flow statement for the year then ended;
- the statement of changes in equity for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union.

In applying the financial reporting framework, the directors have made a number of subjective judgements, for example in respect of significant accounting estimates. In making such estimates, they have made assumptions and considered future events.

What an audit of financial statements involves

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)"). 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 and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on matter prescribed by the Companies Act 2006

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

Other matters on which we are required to report by exception

Adequacy of accounting records and information and explanations received.

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- 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.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors

As explained more fully in the Statement of Directors' Responsibilities set out on page 79, 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 ISAs (UK & 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.



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

9 July 2014

Income statement for the year ended 31 March 2014

	Note	2014 £m	2013 Restated (Note 5) £m
Revenue		521.5	500.1
Operating costs	7		
Manpower costs		(39.9)	(38.9)
Raw materials and consumables used		(16.1)	(14.7)
Other operating expenses		(134.9)	(129.4)
Depreciation		(103.9)	(102.3)
Operating profit		226.7	214.8
Finance costs	8	(67.6)	(71.6)
Finance income	8	3.1	3.4
Net finance costs before exceptional item		(64.5)	(68.2)
Exceptional item	6	-	12.5
Profit before tax		162.2	159.1
Current tax charge	9	(28.6)	(44.6)
Deferred tax credit	9	29.9	15.1
Taxation		1.3	(29.5)
Profit for the year		163.5	129.6

The notes on pages 87 to 128 form part of these financial statements.

Statement of comprehensive income for the year ended 31 March 2014

		2014	2013 (Restated note 5)
	Note	£m	£m
Profit for the year		163.5	129.6
Other comprehensive income/(loss)			
<i>Items which will not be reclassified to profit or loss</i>			
Actuarial losses on defined benefit schemes	24	22.8	(4.2)
Income tax on items that will not be reclassified		(6.7)	(0.1)
Total items that will not be reclassified to profit or loss		16.1	(4.3)
<i>Items that may be reclassified to profit or loss</i>			
Cash flow hedges:			
Net fair value gains/(losses)		37.8	(7.9)
Exceptional item	6	-	2.9
Income tax on items that may be reclassified	25	(6.4)	(2.0)
Total items that may be reclassified to profit or loss		31.4	(7.0)
Other comprehensive income/(loss) for the year net of tax		47.5	(11.3)
Total comprehensive income for the year		211.0	118.3

The notes on pages 87 to 128 form part of these financial statements.

Balance sheet at 31 March 2014

	Note	2014	2013	2012
		£m	Restated (Note 5) £m	Restated (Note 5) £m
Assets				
Non-current assets				
Property, plant and equipment	13	2,595.0	2,555.3	2,541.1
Derivative financial instruments	19	6.6	-	-
Investment in subsidiary undertakings	16	3.3	3.3	3.3
Investment in joint venture	16	-	0.1	0.1
Trade and other receivables	15	0.3	0.4	1.0
		2,605.2	2,559.1	2,545.5
Current assets				
Inventories	17	4.4	3.8	3.7
Trade and other receivables	18	111.1	101.8	85.3
Derivative financial instruments	19	1.8	-	-
Cash and cash deposits	20	315.8	234.4	293.6
		433.1	340.0	382.6
Liabilities				
Current liabilities				
Borrowings	22	(142.5)	(53.4)	(68.7)
Derivative financial instruments	19	(16.5)	(20.0)	(13.5)
Trade and other payables	21	(76.0)	(87.2)	(81.2)
Current tax liabilities		(34.1)	(49.6)	(32.2)
Provisions for liabilities and charges	26	(2.4)	(3.2)	(3.7)
		(271.5)	(213.4)	(199.3)
Net current assets		161.6	126.6	183.3
Non-current liabilities				
Borrowings	22	(1,819.0)	(1,781.4)	(1,809.8)
Other non-current liabilities	23	(68.6)	(63.5)	(61.2)
Derivative financial instruments	19	(3.6)	(31.1)	(29.6)
Retirement benefit obligations	24	(60.8)	(78.4)	(70.5)
Deferred tax liabilities	25	(227.9)	(244.9)	(257.9)
		(2,179.9)	(2,199.3)	(2,229.0)
Net assets		586.9	486.4	499.8
Equity				
Called up share capital	27	150.9	150.9	150.9
Retained earnings and other reserves	29	436.0	335.5	348.9
Total Equity		586.9	486.4	499.8

The notes on pages 87 to 128 form part of these financial statements. The financial statements on pages 82 to 128 were approved by the Board of Directors on 8 July 2014 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

Statement of changes in equity for the year ended 31 March 2014

	Called up share capital (note 27) £m	Retained earnings and other reserves (note 29) £m	Total Equity £m
At 1 April 2012 (Restated note 5)	150.9	348.9	499.8
Profit for the year	-	129.6	129.6
Other comprehensive expense for the year	-	(11.3)	(11.3)
Total comprehensive income for the year	-	118.3	118.3
Transactions with owners			
Dividends paid	-	(133.0)	(133.0)
Share based payments	-	1.3	1.3
Total transactions with owners	-	(131.7)	(131.7)
At 31 March 2013 (Restated note 5)	150.9	335.5	486.4
Profit for the year	-	163.5	163.5
Other comprehensive income for the year	-	47.5	47.5
Total comprehensive income for the year	-	211.0	211.0
Transactions with owners			
Dividends paid	-	(112.0)	(112.0)
Share based payments	-	1.5	1.5
Total transactions with owners	-	(110.5)	(110.5)
At 31 March 2014	150.9	436.0	586.9

The notes on pages 87 to 128 form part of these financial statements.

Cash flow statement for the year ended 31 March 2014

	Note	2014 £m	2013 £m
Cash flows from operating activities			
Cash generated from operations	30	313.7	307.4
Interest paid		(60.1)	(63.0)
Tax paid		(44.1)	(34.0)
Net cash generated from operating activities		<u>209.5</u>	<u>210.4</u>
Cash flows from investing activities			
Interest received		1.3	1.4
Exceptional item	6	-	15.4
Receipt of grants and contributions		2.4	1.0
Purchase of property, plant and equipment		(146.5)	(111.9)
Proceeds from sale of property, plant and equipment		1.9	1.6
Net cash used in investing activities		<u>(140.9)</u>	<u>(92.5)</u>
Cash flows from financing activities			
Deposit of restricted funds		(26.8)	(25.3)
Proceeds from new borrowing		125.0	-
Repayment of borrowings		(21.1)	(21.1)
Finance lease sale and lease back		40.7	85.5
Finance lease principal repayments		(21.3)	(95.3)
Dividends paid		(112.0)	(133.0)
Net cash used in financing activities		<u>(15.5)</u>	<u>(189.2)</u>
Net increase/(decrease) in cash and cash equivalents		53.1	(71.3)
Cash and cash equivalents at beginning of the year	20	98.5	169.8
Cash and cash equivalents at end of the year	20	<u>151.6</u>	<u>98.5</u>

The notes on pages 87 to 128 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 78. The nature of the company's operations and its principal activities are set out on page 78.

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 transfers of assets from customer and certain financial instruments as described in accounting policy note (t) 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 and 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 in preparing these financial statements as stated by the Directors on page 40.

The following standards have been adopted by the company for the first time for the financial year beginning 1 April 2013 and have a material impact on the company:

IAS 19 (revised) 'Employee Benefits' adopted by the company with effect from 1 April 2013, has been applied retrospectively in accordance with the transition provision in the standard. The primary impacts of the revised standard are to increase net finance costs, operating costs and to reduce pension liabilities. The comparative financial information has been restated accordingly (see note 5).

The following standards have been adopted by the company for the first time for the financial year beginning on 1 April 2013 and have an impact on disclosure:

IAS 1 (amended) 'Financial statement presentation' changes the grouping of items presented in the company's Statement of Comprehensive Income so that items which may be reclassified to profit or loss in the future are presented separately from items that will never be reclassified. The amendment affects presentation only and has no impact in the company's financial position or performance.

IFRS 13 'Fair Value Measurement' adopted by the company with effect from 1 April 2013, requires additional disclosures on fair value measurement and categorisation. These financial statements have been prepared under the revised disclosure requirements.

Other standards or interpretations which were mandatory for the first time in the year beginning 1 April 2013 did not have a material impact on the net assets or results of the company.

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

NOTES TO THE FINANCIAL STATEMENTS

(b) Basis of consolidation

The company is exempt under the provisions of section 400 of the Companies Act 2006 from the requirement to produce group financial statements as it is a wholly-owned subsidiary of Pennon Group Plc which is registered within the European Economic Area and which itself produces consolidated financial statements. Accordingly consolidated financial statements have not been prepared and the financial information presented is for the company as an individual undertaking. Group financial statements are included in the Annual Report of Pennon Group Plc which is available from Peninsula House, Rydon Lane, Exeter, Devon, England, EX2 7HR.

(c) Revenue recognition

Revenue represents the fair value of consideration receivable, excluding value added tax and 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.

(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 evenly over their useful economic lives and are principally:

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.

NOTES TO THE FINANCIAL STATEMENTS

ii) *Other assets (including property, overground plant and equipment)*

Other assets are included at cost less accumulated depreciation.

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

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. Assets transferred from customers are recognised at fair value as set out in accounting policy (t).

The assets' residual values and useful lives are reviewed, and adjusted if appropriate.

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.

(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.

NOTES TO THE FINANCIAL STATEMENTS

(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) Investment in 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:

i) Loans and receivables

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

Gains and losses are recognised in the income statement when the instruments are derecognised or impaired. Premia, discounts and other costs and fees are recognised in the income statement through the amortisation process.

Borrowings are classified as current liabilities unless the company has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

ii) 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.

iii) 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.

iv) Derivative financial instruments and hedging activities

The company uses derivative financial instruments, principally interest rate swaps, to hedge risks associated with interest 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.

NOTES TO THE FINANCIAL STATEMENTS

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 recognised in 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 reperfomed at the end of each reporting period to ensure that the hedge remains highly effective.

Where a non-derivative transaction or series of transactions with the same counterparty has the aggregate effect in substance of a derivative instrument, the transaction or series of transactions shall be recognised as a single derivative instrument at fair value with associated movements recorded in the income statement.

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 deemed held for trading 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.

v) *Financial instruments at fair value through profit*

Financial instruments 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.

(n) **Taxation including deferred tax**

The tax credit/(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.

NOTES TO THE FINANCIAL STATEMENTS

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) Contingent liabilities

The company is subject to litigation from time to time as a result of its activities. The company establishes provisions in connection with litigation where it has a present legal or constructive obligation as a result of past events and where it is more likely than not an outflow of resources will be required to settle the obligation and the amount can be reliably estimates.

There are contingent liabilities that arise in the normal course of business which, if realised, are not expected to result in a material liability to the company.

(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 Annual General Meeting.

(r) Employee benefits

i) Retirement benefit obligations

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

Defined benefit pension schemes

The liability recognised in the balance sheet in respect of defined benefit pension plans is the present value of the defined benefit obligation at the end of the year less the fair value of plan assets. The defined benefit obligation is calculated by independent actuaries who advise on the selection of Directors' best estimates, using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates of high quality corporate bonds, and that have terms to maturity approximating to the terms of the related pension obligation. The increase in liabilities of the Group's defined benefit pension schemes, expected to arise from employee service in the year, is charged against operating profit.

The movement in the fair value of scheme assets and the present value of scheme liabilities are shown in notional interest within finance income and cost.

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

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to equity in the statement of comprehensive income in the period to which they arise.

Defined contribution scheme

Costs of the defined contribution pension scheme are charged to the income statement in the year in which they arise. The company has no further obligations once the contributions have been paid.

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.

NOTES TO THE FINANCIAL STATEMENTS

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.

(s) Fair values

The fair value of 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.

(t) Transfers of assets from customers

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

The fair value of assets on transfer from customers is determined using a cost valuation approach allowing for depreciation.

(u) 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.

NOTES TO THE FINANCIAL STATEMENTS

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 inflation and interest rate risk.

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

These risks and treasury operations are managed in accordance with policies established by the Board. Major transactions are individually approved by the Board. Treasury activities are reported to the Board and are subject to review by internal audit.

Financial instruments are used to raise finance, manage risk, optimise the use of surplus funds and manage overall interest rate performance. The company does not engage in speculative activity.

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 64% (2013: 58%) of net borrowings were at fixed rates and 24% (2013: 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 19.

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.

The company has no significant interest-bearing assets upon which the net return fluctuates from market risk. Deposit interest receivable is expected to fluctuate in line with interest payable on floating rate borrowings. Consequently the company's income and cash generated from operations (note 30) are independent of changes in market interest rates.

At 31 March 2014, 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 £0.2m (2013: £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 £1.5m (2013: £1.4m)

ii) Liquidity risk

The company actively maintains a mixture of long-term and short-term committed facilities which 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 22.

NOTES TO THE FINANCIAL STATEMENTS

Contractual undiscounted cash flows including interest payments, at the balance sheet date were:

31 March 2014

	Due within 1 year £m	Due between 1 and 2 years £m	Due between 2 and 5 years £m	Over 5 years £m	Total £m
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	31.1	31.1	111.8	1,377.2	1,551.2
Interest payments on borrowings	10.3	11.4	36.3	623.2	681.2
Finance lease liabilities including interest	55.4	67.0	210.8	2,034.8	2,368.0
Derivative financial liabilities					
Derivative contracts – net payments	19.3	8.1	12.5	(7.9)	32.0

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
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	21.1	31.1	93.3	1,237.5	1,383.0
Interest payments on borrowings	9.2	9.3	28.4	617.7	664.6
Finance lease liabilities including interest	47.6	56.7	209.6	2,038.8	2,352.7
Derivative financial liabilities					
Derivative contracts – net payments/(receipts)	19.1	26.3	26.3	8.6	80.3

iii) Credit risk

Credit counterparty risk arises from cash and cash deposits, derivative financial instruments and exposure to customers, including outstanding receivables. Further information on the credit risk relating to trade receivables is given in note 18.

Counterparty risk arises from the investment of surplus funds and from the use of derivative financial instruments. The Board has agreed a policy for managing such risk, which is controlled through credit limits, counterparty approvals, and rigorous monitoring procedures. The company has no other significant concentration of credit risk. Surplus funds of the company are usually placed in short-term fixed interest deposits or the overnight money markets. Deposit counterparties must meet a credit rating threshold set by the Board of P1 (Moody's) or A1 (Standard and Poor's).

(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 minimise the cost of capital.

The company's policy is to have a minimum of 12 months pre-funding of projected capital expenditure. At 31 March 2014 the company had cash and facilities excluding restricted funds of almost £400m, meeting this objective.

NOTES TO THE FINANCIAL STATEMENTS

The company monitors capital on the basis of the gearing ratio, which is calculated as net borrowings divided by total capital. Net borrowings are analysed in note 31 and is calculated as total borrowings less cash and cash deposits. Total capital is calculated as equity plus net borrowings.

The gearing ratios at the balance sheet date were:

	2014	2013
	£m	£m
Net Borrowings (note 31)	1,645.7	1,600.4
Total equity	586.9	486.4
Total capital	2,232.6	2,086.8
Gearing Ratio	73.7%	76.7%

Consistent with the industry peer group, the Company is also monitored on the basis of the ratio of its Debt to Regulated Capital Value (RCV). Ofwats optimum range for this is 55% - 65%.

	2014	2013
	£m	£m
Regulatory Capital Value	2,958.8	2,915.7
Net borrowings (note 31)	1,645.7	1,600.4
Net borrowings / Regulatory Capital Value	56%	55%

The company has entered into covenants with lenders and, whilst terms vary, these typically provide for limits on gearing and interest cover. The company has been in compliance with its covenants during the year.

(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 company's financial instruments are valued principally using level 2 measures as analysed in note 19.

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. A variety of methods and assumptions are used 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.

NOTES TO THE FINANCIAL STATEMENTS

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

4. Critical accounting judgements and estimates

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

Estimates are based on factors including historical experience and expectations of future events that management believe to be reasonable. However, given the judgemental nature of such estimates, actual results could be different from the assumptions used:

(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 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 the 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. As at 31 March 2014 the company's current trade receivables were £103.6m, against which £82.1m had been provided for impairment (note 18).

(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 last valuation of the main scheme was at 31 March 2010 and the 31 March 2013 valuation is being finalised.

The pension cost and liabilities under IAS 19 (revised), 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 member data supplied to the actuary and market observations for interest rates and inflation, supplemented by discussions between the actuary and management. The mortality assumption uses a scheme-specific calculation based on CMI 2013 actuarial tables with an allowance for future longevity improvement. The principal assumptions used to measure schemes' liabilities, sensitivities to changes in those assumptions and future funding obligations are set out in note 24 of the financial statements.

NOTES TO THE FINANCIAL STATEMENTS

(d) Taxation

The company's current tax provision of £34.1m 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 the tax position is uncertain.

(e) 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 2014 was £2,595.0m. In the year ended 31 March 2014 additions to property, plant and equipment totalled £141.6m and the depreciation charge was £106.1m. Estimated useful economic lives of property, plant and equipment are based on management's judgement and experience.

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

NOTES TO THE FINANCIAL STATEMENTS

5. Restatement

IAS 19 (revised) 'Employee Benefits' has been applied retrospectively in accordance with the transition provision in the standard; comparative information has been restated accordingly.

	Note	Previously reported	2013 Application of IAS 19 (Revised)	Restated as now reported
		£m	£m	£m
Income Statement				
Manpower costs		(38.5)	(0.4)	(38.9)
Finance costs	8	(88.9)	17.3	(71.6)
Finance income	8	25.7	(22.3)	3.4
Taxation		(30.7)	1.2	(29.5)
Profit for the year		133.8	(4.2)	129.6
Statement of comprehensive income				
Profit for the year		133.8	(4.2)	129.6
Actuarial losses on defined benefit schemes	24	(10.4)	4.8	(5.6)
Total comprehensive income for the year		117.7	0.6	118.3

		2013			2012		
		Previously reported	Application of IAS 19 (Revised)	Restated as now reported	Previously reported	Application of IAS 19 (Revised)	Restated as now reported
Balance Sheet							
<i>Non-current liabilities</i>							
Retirement benefit obligations	24	(86.6)	8.2	(78.4)	(77.9)	7.4	(70.5)
Deferred tax liabilities		(243.0)	(1.9)	(244.9)	(256.2)	(1.7)	(257.9)
<i>Equity</i>							
Retained earnings and other reserves	29	329.2	6.3	335.5	343.2	5.7	348.9

NOTES TO THE FINANCIAL STATEMENTS

6. Exceptional Item

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

	2014	2013
	£m	£m
Net finance costs:		
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)
Profit on exceptional item before tax	-	12.5
Tax arising on exceptional item:		
current tax	-	(3.7)
deferred tax	-	0.7
	-	(3.0)
Profit after tax on exceptional item	-	9.5

In 2013 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.

7. Operating costs

	2014	2013
	£m	Restated (Note 5) £m
Manpower costs (note 11)	39.9	38.9
Raw materials and consumables	16.1	14.7
Other operating expenses include		
Profit on disposal of property, plant and equipment	(1.7)	(1.4)
Operating lease rentals payable:		
plant and machinery	0.9	1.1
property	1.4	1.4
Research and development expenditure	0.1	0.2
Trade receivables impairment (note 18)	9.5	9.5
Depreciation of property, plant and equipment:		
owned assets	71.6	69.6
under finance leases	32.3	32.7
	103.9	102.3

NOTES TO THE FINANCIAL STATEMENTS

Fees payable to the Company's auditors in the year were:

	2014 £000	2013 £000
Fees payable for the audit of the financial statements	143	123
Fees payable to the Company's auditor for other services:		
Audit related assurance services	210	32
Tax advisory services	56	146
All other services	362	208
Total fees	771	509

Expenses reimbursed to the auditors in relation to the audit of the Company were £14,000 (2013: £12,000).

A description of the work of the Audit Committee is set out in its report on page 39 which included an explanation of how the auditors' objectivity and independence are safeguarded when non-audit services are provided by the auditors' firm.

8. Net finance costs

	2014			2013 Restated (Note 5)		
	Finance cost £m	Finance income £m	Total £m	Finance cost £m	Finance income £m	Total £m
Cost of servicing debt						
Bank borrowings and overdrafts	(10.0)	-	(10.0)	(8.3)	-	(8.3)
Interest element of finance lease rentals	(34.9)	-	(34.9)	(39.9)	-	(39.9)
Other finance costs	(4.1)	-	(4.1)	(3.7)	-	(3.7)
Interest receivable	-	3.1	3.1	-	3.4	3.4
Intercompany interest to subsidiaries	(15.2)	-	(15.2)	(16.6)	-	(16.6)
	(64.2)	3.1	(61.1)	(68.5)	3.4	(65.1)
Notional interest						
Retirement benefit obligations (note 24)	(3.4)	-	(3.4)	(3.1)	-	(3.1)
Finance (costs)/income	(67.6)	3.1	(64.5)	(71.6)	3.4	(68.2)

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

9. Taxation

	2014	2013 Restated (Note 5)
	£m	£m
Analysis of (credit)/charge in year		
Current tax charge	28.6	44.6
Deferred tax arising on change of rate of corporation tax (note 25)	(37.7)	(12.3)
Deferred tax - other	7.8	(2.8)
Total deferred tax credit	<u>(29.9)</u>	<u>(15.1)</u>
Total (credit)/charge for the year	<u>(1.3)</u>	<u>29.5</u>

Current tax is calculated at 23% (2013: 24%) of the estimated assessable profit for the year.

The deferred tax credit for the year is increased by a non-recurring credit of £37.7m (2013: £12.3m) arising from a 3% (2013: 1%) reduction in the rate of corporation tax. From April 2014 a 2% reduction will take place, followed by a further 1% reduction from 1 April 2015.

The tax for the year differs from the theoretical amount that would arise using the standard rate of corporation tax in the UK of 23% (2013: 24%). The differences are explained below:

	2014	2013 Restated (Note 5)
	£m	£m
Profit before tax	<u>162.2</u>	<u>159.1</u>
Profit before tax multiplied by the standard rate of corporation tax in the UK of 23% (2013: 24%)	37.3	38.2
Effects of:		
Expenses not deductible for tax purposes	2.2	1.1
Adjustments to tax charge in respect of prior year	(3.0)	2.7
Change in rate of corporation tax	(37.7)	(12.3)
Other	(0.1)	(0.2)
Tax charge for year	<u>(1.3)</u>	<u>29.5</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 effective tax rate for the year was 18% (2013: 28%).

The company reimburses other Group companies for losses claimed by way of group relief at an amount equal to the tax benefit received.

NOTES TO THE FINANCIAL STATEMENTS

In addition to the amounts recognised in the income statement the following tax charges and credits were also recognised:

	2014	2013
	£m	Restated (Note 5) £m
Amounts recognised directly in other comprehensive income		
Deferred tax charge on defined benefit pension schemes	8.4	0.1
Deferred tax charge on cash flow hedges	4.7	1.7
	<hr/>	<hr/>
Amounts recognised directly in equity		
Deferred tax (credit)/charge on share based payments	(0.2)	0.3
	<hr/>	<hr/>

10. Dividends

	2014	2013
	£m	£m
Amounts recognised as distributions to equity holders in the year:		
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
Base dividend of 43.1p per ordinary share in respect of 2013/14 paid 26 September 13	65.0	-
Dividend of 11.3p per ordinary share in respect of outperformance for 2013/13 and 2013/14 paid 26 September 2013	17.0	-
Special dividend of 19.9p per ordinary share in respect of outperformance for 2013/14 paid 31 March 2014	30.0	-
	<hr/> 112.0	<hr/> 133.0

NOTES TO THE FINANCIAL STATEMENTS

11. Employment costs

The average number of persons (including Executive Directors) employed by the Company was 1,169 (2013: 1,163).

	Note	2014 £m	2013 Restated (Note 5) £m
Wages and salaries		35.4	34.2
Social security costs		3.0	3.1
Pension costs	24	9.4	9.0
Share-based payments		1.3	1.2
Total employment costs		49.1	47.5
Charged as follows:			
Manpower costs		39.9	38.9
Capital schemes		9.2	8.6
Total employment costs		49.1	47.5

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

12. Directors' emoluments

	2014 £000	2013 £000
Executive Directors:		
Salary	751	734
Performance-related bonus paid or payable	277	226
Share-based payments	629	623
Other emoluments, including payments in lieu of pension provision	331	311
Non-executive Directors (including Chairman)	211	206
Total emoluments	2,199	2,100

More detailed information concerning Directors' emoluments (including pensions and the highest paid Director) and share interests is shown in the Directors' remuneration report on pages 82 to 101.

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

The aggregate gains on vesting of Directors' share-based awards amounted to a total of £705,000.

Total gains made by Directors on the exercise of share options were £3,000 (2012/13: £54,000).

At 31 March 2014 there were three Directors accruing retirement benefits under defined benefit pension schemes (2013: three Directors).

NOTES TO THE FINANCIAL STATEMENTS

13. 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
Cost:						
At 1 April 2012	22.3	1,529.4	629.1	1,184.4	109.2	3,474.4
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)	-
At 31 March 2013	23.4	1,559.0	641.1	1,253.1	112.7	3,589.3
Additions	-	13.8	1.2	30.7	95.9	141.6
Assets adopted at fair value	-	5.9	-	0.1	-	6.0
Grants & contributions	-	(1.6)	-	-	-	(1.6)
Disposals	-	(1.2)	(0.4)	(16.6)	-	(18.2)
Transfers/reclassifications	1.0	21.1	7.5	53.9	(83.5)	-
At 31 March 2014	24.4	1,597.0	649.4	1,321.2	125.1	3,717.1
Accumulated depreciation:						
At 1 April 2012	5.3	122.7	185.1	620.2	-	933.3
Charge for year	0.5	23.0	11.2	69.7	-	104.4
Disposals	-	(1.2)	-	(2.5)	-	(3.7)
At 31 March 2013	5.8	144.5	196.3	687.4	-	1,034.0
Charge for year	0.5	23.8	12.3	69.5	-	106.1
Disposals	-	(1.2)	(0.4)	(16.4)	-	(18.0)
At 31 March 2014	6.3	167.1	208.2	740.5	-	1,122.1
Net book value:						
At 31 March 2012	17.0	1,406.7	444.0	564.2	109.2	2,541.1
At 31 March 2013	17.6	1,414.5	444.8	565.7	112.7	2,555.3
At 31 March 2014	18.1	1,429.9	441.2	580.7	125.1	2,595.0

Out of the total depreciation charge for the Company of £106.1m (2013: £104.4m), the sum of £1.3m (2013: £1.3m) has been charged to capital projects, £0.9m (2013: £0.8m) has been offset by deferred income and £103.9m (2013: £102.3m) against profits.

Asset lives and residual values are reviewed annually.

NOTES TO THE FINANCIAL STATEMENTS

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
Cost:						
At 31 March 2013	-	357.0	465.2	370.8	0.3	1,193.3
At 31 March 2014	-	357.0	465.2	411.1	0.2	1,233.5
Accumulated depreciation:						
At 31 March 2013	-	36.6	104.9	157.1	-	298.6
At 31 March 2014	-	41.9	112.8	175.6	-	330.3
Net book amount:						
At 31 March 2013	-	320.4	360.3	213.7	0.3	894.7
At 31 March 2014	-	315.1	352.5	235.5	0.2	903.3

NOTES TO THE FINANCIAL STATEMENTS

14. Financial instruments by category

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

		Fair value	Amortised cost		
	Note	Derivatives used for cash flow hedging £m	Loans and receivables £m	Trade receivables and trade payables £m	Total £m
31 March 2014					
Financial assets					
Trade and other receivables	15 & 18	-	18.0	21.5	39.5
Derivative financial instruments used for cash flow hedging	19	8.4			8.4
Cash and cash deposits	20	-	315.8	-	315.8
		8.4	333.8	21.5	363.7
Financial liabilities					
Borrowings	22	-	(1,961.5)	-	(1,961.5)
Derivative financial instruments	19	(20.1)	-	-	(20.1)
Trade and other payables	21	-	(4.4)	(40.8)	(45.2)
		(20.1)	(1,965.9)	(40.8)	(2,026.8)
31 March 2013					
Financial assets					
Trade and other receivables	15 & 18	-	3.9	36.1	40.0
Cash and cash deposits	20	-	234.4	-	234.4
		-	238.3	36.1	274.4
Financial liabilities					
Borrowings	22	-	(1,834.8)	-	(1,834.8)
Derivative financial instruments used for cash flow hedging	19	(48.2)	-	-	(48.2)
Derivative financial instruments held for trading		(2.9)	-	-	(2.9)
Trade and other payables	21	-	(3.8)	(46.6)	(50.4)
		(51.1)	(1,838.6)	(46.6)	(1,936.3)

£11.7m (2013: £51.1m) of the derivative value above is used for hedging with £0.3m (2013: £nil) deemed as held for trading.

NOTES TO THE FINANCIAL STATEMENTS

15. Non-current trade and other receivables

	2014 £m	2013 £m
Amounts owed by subsidiary company	0.3	0.4

The effective interest rate on amounts owed by subsidiary is 2.3% (2013: 2.3%).

16. Investments

	2014 £m	2013 £m
At 31 March:		
Subsidiary undertakings	3.3	3.3
Joint venture	-	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.

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.

During the year the company's joint venture holding of Echo South West Limited was reduced to 2 A ordinary shares, the board of Echo South West Limited authorised by its members, submitted an application to the Registrar of Companies to request the strike off and removal of the Company from the register of companies. The company was dissolved on 7 January 2014.

17. Inventories

	2014 £m	2013 £m
Raw materials and consumables	4.4	3.8

NOTES TO THE FINANCIAL STATEMENTS

18. Trade and other receivables - current

	2014 £m	2013 £m
Trade receivables	103.6	108.6
Less: provision for impairment of receivables	(82.1)	(72.5)
Net trade receivables	<u>21.5</u>	<u>36.1</u>
Amounts owed by subsidiary companies	0.4	1.1
Amounts owed by fellow subsidiary companies	1.2	1.2
Other receivables	16.1	1.2
Prepayments and accrued income	71.9	62.2
	<u>111.1</u>	<u>101.8</u>

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 practicably 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:

	2014 £m	2013 £m
Past due 1 - 30 days	13.0	22.8
Past due 31 - 120 days	12.3	10.5
More than 120 days	<u>124.4</u>	<u>110.5</u>

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

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

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

	2014 £m	2013 £m
At 1 April	72.5	63.0
Provision for receivables impairment	9.6	9.5
Receivables written-off during the year as uncollectable	(7.9)	(9.1)
Cumulative amounts previously excluded from debt	7.9	9.1
At 31 March	<u>82.1</u>	<u>72.5</u>

NOTES TO THE FINANCIAL STATEMENTS

19. Derivative financial instruments

	2014 £m	2013 £m
<i>Derivatives used for cash flow hedging:</i>		
Current assets	1.8	-
Non-current assets	6.6	-
Current liabilities	(16.5)	(18.6)
Non-current liabilities	(3.6)	(29.6)

Derivatives deemed held for trading:

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 (2013: £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 2014, 64% (2013: 58%) of net borrowings was at fixed rate.

At 31 March 2014 interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £1,313.0m existed, with a weighted average maturity of 3.6 years (2013: £1,135.0m, with 4.1 years). The weighted average interest rate of the swaps was 2.7% (2013: 2.7%).

Valuation hierarchy

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

	2014 £m	2013 £m
Level 2 inputs		
Assets		
Derivatives used for cash flow hedging	8.4	-
Liabilities		
Derivatives used for cash flow hedging	(20.1)	(48.2)
Derivatives deemed held for trading	-	(2.9)

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.

NOTES TO THE FINANCIAL STATEMENTS

20. Cash and cash deposits

	2014 £m	2013 £m
Cash at bank and in hand	41.6	33.5
Overnight deposits	55.0	-
Other short-term bank deposits	55.0	65.1
Other deposits	164.2	135.8
	<u>315.8</u>	<u>234.4</u>

Short-term deposits have an average maturity of one day.

Other deposits have an average maturity of 58 days

Other deposits include £164.2m (2013: £135.8m) of restricted funds to settle long-term lease liabilities (note 22).

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

	2014 £m	2013 £m
Cash and cash deposits as above	315.8	234.4
Less: deposits with a maturity of three months or more (restricted funds)	(164.2)	(135.9)
Cash and cash equivalents	<u>151.6</u>	<u>98.5</u>

21. Trade and other payables - current

	2014 £m	2013 £m
Trade payables	40.8	46.6
Amounts owed to parent undertaking	1.2	0.7
Amounts owed to subsidiary companies	3.2	3.2
Other tax and social security	1.2	10.3
Other payables	10.2	6.8
Accruals	18.5	18.7
Deferred income	0.9	0.9
	<u>76.0</u>	<u>87.2</u>

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

NOTES TO THE FINANCIAL STATEMENTS

22. Borrowings

	2014 £m	2013 £m
Current		
European Investment Bank	31.1	21.1
	<u>31.1</u>	<u>21.1</u>
Obligations under finance leases	111.4	32.3
Total current borrowings	<u>142.5</u>	<u>53.4</u>
Non-current		
European Investment Bank	304.3	210.4
Loan from subsidiary company (note 35)	386.5	379.8
	<u>690.8</u>	<u>590.2</u>
Obligations under finance leases	1,128.2	1,191.2
	<u>1,819.0</u>	<u>1,781.4</u>
Total borrowings	<u>1,961.5</u>	<u>1,834.8</u>

The loan from subsidiary company represents loans from SWW 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 fair value of the non-current borrowings were:

	2014		2013	
	Book value £m	Fair value £m	Book value £m	Fair Value £m
European Investment Bank	304.3	260.1	210.4	189.5
Loan from subsidiary company	386.5	326.6	379.8	341.8
	<u>690.8</u>	<u>586.7</u>	590.2	531.3
Obligations under finance leases	1,128.2	955.6	1,191.2	1,022.8
	<u>1,819.0</u>	<u>1,542.3</u>	1,781.4	1,554.1

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

NOTES TO THE FINANCIAL STATEMENTS

The maturity of non-current borrowings was:

	2014 £m	2013 £m
Between 1 and 2 years	55.2	66.2
Over 2 and less than 5 years	190.0	232.4
Over 5 years	1,573.8	1,482.8
	<u>1,819.0</u>	<u>1,781.4</u>

The weighted average maturity of non-current borrowings was 25 years (2013: 27years)

Finance lease liabilities - minimum lease payments:

	2014 £m	2013 £m
Within 1 year	55.4	47.4
Over 1 year and less than 5 years	277.8	266.3
Over 5 years	2,034.8	2,038.8
	<u>2,368.0</u>	<u>2,352.5</u>
Less: future finance charges	<u>(1,128.5)</u>	<u>(1,129.0)</u>
Present value of finance lease liabilities	<u>1,239.5</u>	<u>1,223.5</u>

The maturity of finance lease liabilities was:

	2014 £m	2013 £m
Within 1 year	111.4	32.3
Over 1 year and less than 5 years	102.3	174.2
Over 5 years	1,025.8	1,017.0
	<u>1,239.5</u>	<u>1,223.5</u>

Included above are accrued finance charges arising on obligations under finance leases totalling £127.3m (2013: £130.8m), of which £6.9m (2013: £14.3m) is repayable within one year.

Included above is £0.6m (2013: £0.7m) due to Peninsula Leasing Limited, a subsidiary company, under finance lease agreements of which £0.4m (2013: £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 which 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 £60.1m at 31 March 2014 (2013: £52.4m) are being held to settle the lease liability over the period from the end of the original lease term. The deposits are subject to a registered charge given as security to the lessor for the balance outstanding.

NOTES TO THE FINANCIAL STATEMENTS

The period for repayment of certain existing leases includes an agreement to deposit with the lessor group amounts equal to the difference between the original and revised payments due. The accumulated deposit at 31 March 2014 of £104.1m (2013: £83.5m) 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.

Undrawn committed borrowing facilities at the balance sheet date were:

	2014	2013
	£m	£m
Floating rate:		
Expiring within one year	30.0	-
Expiring after one year	245.0	105.0
	<u>275.0</u>	<u>105.0</u>

In addition, the company has undrawn uncommitted short-term bank facilities of £25.0m (2013: £25.0m).

23. Other non-current liabilities	2014	2013
	£m	£m
Deferred income	<u>68.6</u>	<u>63.5</u>

Deferred income results from the adoption at fair value of assets transferred from customers.

24. Retirement benefit obligations

The Company's employees are eligible to participate in defined benefit pension schemes and also a defined contribution section within the main scheme, operated by the parent company, Pennon Group Plc.

The assets of the Pennon 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 Pennon Group has a policy for the main fund that one-half of all trustees, other than the Chairman, are nominated by members of the schemes, including pensioners.

Defined contribution schemes

Pension costs for defined contribution schemes were £0.5m (2012: £0.4m).

Defined benefit schemes

The principal actuarial assumptions at 31 March 2014 were:

	2014	2013	2012
	%	%	%
Rate of increase in pensionable pay	<u>3.4</u>	3.4	3.5
Rate of increase for current and future pensions	<u>3.2</u>	3.4	3.3
Rate used to discount schemes' liabilities and expected return on scheme assets	<u>4.30</u>	4.35	4.73
Inflation	<u>3.4</u>	3.4	3.3

NOTES TO THE FINANCIAL STATEMENTS

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 2013 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:

	2014	2013	2012
Male	24.9	25.0	24.9
Female	27.1	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 as:

	2014	2013	2012
Male	26.3	25.9	25.8
Female	29.4	28.3	28.2

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

	Change in assumption	Impact on schemes' liabilities
Rate of increase in pensionable pay	+/- 0.5%	+/- 1.3%
Rate of increase in current and future pensions	+/- 0.5%	+/- 6.4%
Rate used to discount schemes' liabilities	+/- 0.5%	+/- 8.9%
Inflation	+/- 0.5%	+/- 6.9%
Life expectancy	+/- 1 year	+/- 3.5 %

The amounts recognised in the balance sheet were:

	2014	2013
		Restated (Note 5)
	£m	£m
Present value of funded obligations	(465.5)	(472.4)
Fair value of plan assets	404.7	394.0
Net liability recognised in the balance sheet	(60.8)	(78.4)

NOTES TO THE FINANCIAL STATEMENTS

The movement in the net defined benefit obligation over the accounting period is as follows:

	2014			2013		
	Present value of obligation	Fair value of plan assets	Total	Present value of obligation	Fair value of plan assets	Total
	£m	£m	£m	£m	£m	£m
At 1 April	(472.4)	394.0	(78.4)	(424.2)	353.7	(70.5)
Current service cost	(8.7)	-	(8.7)	(8.3)	-	(8.3)
Interest income/(expense)	(20.4)	17.0	(3.4)	(20.1)	17.0	(3.1)
Past service cost and gains and losses on settlements	(0.2)	-	(0.2)	(0.3)	-	(0.3)
	(29.3)	17.0	(12.3)	(28.7)	17.0	(11.7)
Remeasurements:						
Return on plan on assets excluding amounts included in interest expense	-	1.6	1.6	-	31.0	31.0
Gain/(loss) from change in demographic assumptions	(3.2)	-	(3.2)	-	-	-
Gain/(loss) from change in financial assumptions	8.7	-	8.7	(36.2)	-	(36.2)
Experience gains	15.7	-	15.7	1.0	-	1.0
	21.2	1.6	22.8	(35.2)	31.0	(4.2)
Contributions:						
Employers	-	7.1	7.1	-	8.0	8.0
Plan participants	(0.1)	0.1	-	(0.1)	0.1	-
Payments from plans:						
Benefit payments	15.1	(15.1)	-	15.8	(15.8)	-
	15.0	(7.9)	7.1	15.7	(7.7)	8.0
At 31 March	(465.5)	404.7	(60.8)	(472.4)	394.0	(78.4)

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

	2014		2013	
	Quoted prices in active market	Fund	Quoted prices in active market	Fund
	£m	%	£m	%
Equities	194.0	48	203.5	52
Property	30.0	7	27.1	7
Bonds	124.6	31	131.0	33
Diversified Growth Fund	54.8	14	30.9	8
Other	1.3	-	1.5	-
	404.7	100	394.0	100

Other assets principally represent cash contributions received from the company towards the year-end which are invested during the subsequent financial year.

NOTES TO THE FINANCIAL STATEMENTS

Through the Pennon Group defined benefit pension plan, the company is exposed to a number of risks, the most significant of which are detailed below:

Asset volatility: The liabilities are calculated using a discount rate set with reference to corporate bond yields; if assets underperform this yield, this will create a deficit. The schemes hold a significant proportion of growth assets (equities and diversified growth funds) which are expected to outperform corporate bonds in the long-term but can give rise to volatility and risk in the short-term. The allocation to growth assets is monitored such that it is suitable with the scheme's long-term objectives.

Changes in bond yields: A decrease in corporate bond yields will increase the scheme's liabilities, although this will be partially offset by an increase in the value of the scheme's bond holdings.

Inflation risk: The majority of the scheme's benefit obligations are linked to inflation, and higher inflation will lead to higher liabilities (although, in most cases, caps on the level of inflationary increases are in place to protect against extreme inflation). The majority of the assets are either unaffected by or loosely correlated with inflation, meaning that an increase in inflation will also increase the deficit.

Life expectancy: The majority of the scheme's obligations are to provide benefits for the life of the member, so increases in life expectancy will result in an increase in the liabilities. In conjunction with its investment advisors, the trustees have structured the schemes' investments with the objectives of balancing investment returns and levels of risk. The asset allocation has three principal 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 in alternative asset classes which give the potential for diversification (currently property and diversified growth).

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 increases in pensionable pay.

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 last triennial actuarial valuation of the principal defined benefit scheme was at 31 March 2010. The company paid no deficit recovery contributions to the main scheme during the year (2013: £nil) since all payments up to 31 March 2015 under the existing schedule of contributions have been made. The schedule of contributions is due to be revised following the completion of the 31 March 2013 triennial actuarial valuation. The Pennon Group monitors funding levels on an annual basis and South West Water expects to pay total contributions of around £7.2m during the year ended 31 March 2015.

NOTES TO THE FINANCIAL STATEMENTS

25. Deferred tax liabilities

Deferred tax is provided in full on temporary differences under the liability method using a tax rate of 20% (2013: 23%).

The movements on deferred tax were:	2014	2013 Restated (Note 5)
	£m	£m
At 1 April	244.9	257.9
Impact of change of corporation tax rate credited to the income statement	(37.7)	(12.3)
Impact of change of corporation tax rate charged to equity	3.5	1.7
Other deferred tax charged/(credited) to the income statement	7.8	(2.1)
Other deferred tax credited to the income statement - exceptional item	-	(0.7)
Charged to equity	9.4	0.4
At 31 March	<u>227.9</u>	<u>244.9</u>

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

The majority of the company's deferred liability is expected to be recovered over more than one year.

All deferred tax assets and liabilities within the same Jurisdiction are offset.

The deferred tax balance has been reduced by a net credit of £34.2m to recognise the changes in the rate of corporation tax enacted on 17 July 2013 to reduce the rate from 1 April 2014 from 23% to 21%. From 1 April 2014, 2% of the reduction will take place, followed by a further 1% reduction from 1 April 2015.

The movements in deferred tax assets and liabilities were:

Deferred tax liabilities

	Accelerated tax depreciation		Total
	Owned Assets	Leased Assets	
	£m	£m	£m
At 1 April 2012	275.9	15.8	291.7
Impact of change of rate (Credited)/charged to the income statement	(11.2)	(0.7)	(11.9)
	<u>(7.0)</u>	<u>0.7</u>	(6.3)
At 31 March 2013	257.7	15.8	273.5
Impact of change of rate	(34.6)	(2.1)	(36.7)
Charged to the income statement	7.5	0.7	8.2
At 31 March 2014	<u>230.6</u>	<u>14.4</u>	<u>245.0</u>

NOTES TO THE FINANCIAL STATEMENTS

Deferred tax assets

	Provisions £m	As restated Retirement benefit obligations £m	Other £m	Total £m
At 1 April 2012 (Restated note 5)	(4.3)	(17.0)	(12.5)	(33.8)
Charged/(credited) to the income statement	4.3	(0.8)	-	3.5
(Credited)/charged to equity	-	(1.1)	1.5	0.4
Impact of change in rate	-	0.9	0.4	1.3
At 31 March 2013 (Restated note 5)	-	(18.0)	(10.6)	(28.6)
(Credited)/charged to the income statement	(0.2)	(1.3)	1.1	(0.4)
Charged to equity	-	5.3	4.1	9.4
Impact of change in rate	-	1.8	0.7	2.5
At 31 March 2014	(0.2)	(12.2)	(4.7)	(17.1)

Net deferred tax liability:	£m
At 31 March 2013 (Restated note 5)	244.9
At 31 March 2014	227.9

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

	2014 £m	2013 Restated (Note 5) £m
Actuarial gains/(losses) on defined benefit schemes	5.3	(1.1)
Actuarial gains on defined benefit schemes (change of rate)	3.1	1.2
Share-based payments	(0.2)	0.2
Share-based payments (change of rate)	-	0.1
Cash-flow hedges	4.3	1.3
Cash flow hedges (change in rate)	0.4	0.4
	12.9	2.1

NOTES TO THE FINANCIAL STATEMENTS

26. Provisions

Restructuring	2014	2013
	£m	£m
At 1 April	3.2	3.7
Charged to the income statement	0.5	0.5
Utilised during year	(1.3)	(1.0)
At 31 March	<u>2.4</u>	<u>3.2</u>

The restructuring provision is expected to be utilised within one year.

27. Called up share capital

	2014	2013
	£m	£m
Authorised		
500,000,000 (2013: 500,000,000) Ordinary shares of £1 each	<u>500.0</u>	<u>500.0</u>
Allotted and fully paid		
150,950,000 (2013: 150,950,000) Ordinary shares of £1 each	<u>150.9</u>	<u>150.9</u>

NOTES TO THE FINANCIAL STATEMENTS

28. Employee share schemes

The company participates in a number of share plans for the benefit of employees operated by Pennon Group Plc. 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 Ordinary 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:

Date granted and subscription price fully paid	Period when options normally exercisable	Thousands of shares in respect of which options outstanding at 31 March		
		2014	2013	
4 July 2006	358p	2009 - 2013	-	20
3 July 2007	522p	2010 - 2014	5	5
8 July 2008	517p	2011 - 2015	7	34
6 July 2009	386p	2012 - 2016	218	220
28 June 2010	431p	2013 - 2017	114	282
29 June 2011	536p	2014 - 2018	200	206
29 June 2012	588p	2015 - 2017	299	372
3 July 2013	538p	2016 - 2018	297	-
			1,140	1,139

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

	2014		2013	
	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	1,139	494	1,367	425
Granted	306	588	382	588
Exercised	(212)	437	(497)	390
Expired	(93)	515	(113)	433
At 31 March	1,140	511	1,139	494

The weighted average price at the date of exercise of Sharesave options during the year was 703p (2013: 731p). The options outstanding at 31 March 2014 had a weighted average exercise price of 511p (2013: 494p) and a weighted average remaining contractual life of 1.7 year (2013: 2.0 years).

NOTES TO THE FINANCIAL STATEMENTS

The aggregate fair value of sharesave options granted during the year was £0.3m (2013: £0.4m), determined using the Black-Scholes valuation model. The significant inputs into the valuation model, at the date of issue of the options, were:

	2014	2013
Weighted average share price	673p	735p
Weighted average exercise price	538p	588p
Expected volatility	18.0%	19.0%
Expected life	3.4 years	3.4 years
Risk-free rate	0.7%	0.4%
Expected dividend yield	4.2%	4.0%

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

ii) Performance and Co-investment Plan

Executive Directors and senior management receive a conditional award of Ordinary shares in Pennon Group Plc, and are also required to hold a substantial personal share holding in Pennon Group Plc. 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 price of shares in the Performance and Co-investment Plan are:

	2014		2013	
	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	353	663	404	565
Granted	135	653	109	769
Vested	(73)	546	(128)	487
Lapsed	(58)	546	(32)	487
At 31 March	357	703	353	663

The awards outstanding at 31 March 2014 had a weighted average exercise price of 703p (2013: 663p) and a weighted average remaining contractual life of 1.3 years (2013: 1.3 years).

The aggregate fair value of awards granted during the year was £0.5m (2013: £0.5m), determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were:

	2014	2013
Weighted average share price	653	768p
Expected volatility	18.0%	19.0%
Risk-free rate	0.7%	0.4%

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

NOTES TO THE FINANCIAL STATEMENTS

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 conditional upon continuous service with the Pennon Group for a period of three years from the award.

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

	2014		2013	
	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	159	677	158	589
Granted	47	754	50	755
Vested	(58)	569	(49)	473
At 31 March	148	698	159	677

The awards outstanding at 31 March 2014 had a weighted average price of 698p (2013: 677p) and a weighted average remaining contractual life of 1.0 years (2013: 1.3 years). The Group's share price at the date of the awards ranged from 725p to 755p.

The aggregate fair value of awards granted during the year was £0.3m (2013: £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.

Further details of the plans and options granted to Directors, included above, are shown in the Directors' remuneration report.

NOTES TO THE FINANCIAL STATEMENTS

29. Retained earnings and other reserves

	Hedging reserve Restated (Note 5) £m	Retained earnings Restated (Note 5) £m	Total Restated (Note 5) £m
At 1 April 2012	(34.3)	383.2	348.9
Profit for the year	-	129.6	129.6
Other comprehensive expense for the year	(7.9)	(6.3)	(14.2)
Other comprehensive income - exceptional item	2.9	-	2.9
Dividends paid	-	(133.0)	(133.0)
Share-based payments (including 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
At 31 March 2013	(39.3)	374.8	335.5
Profit for the year	-	163.5	163.5
Other comprehensive expense for the year	31.4	16.1	47.5
Dividends paid	-	(112.0)	(112.0)
Share-based payments (including tax)	-	1.4	1.4
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
At 31 March 2014	(7.9)	443.9	436.0

NOTES TO THE FINANCIAL STATEMENTS

30. Cash flow from operating activities

Reconciliation of profit for the year to cash generated from operations:

Cash generated from operations

	2014	2013
		Restated (Note 5)
	£m	£m
Continuing operations		
Profit for the year	163.5	129.6
Adjustments for:		
Share based payments	1.3	1.4
Deferred income released to profits	(0.2)	(0.2)
Profit on disposal of property, plant and equipment	(1.7)	(1.4)
Depreciation charge	103.9	102.3
Interest payable and similar charges	67.6	71.6
Interest receivable	(3.1)	(3.4)
Taxation	(1.3)	29.5
Exceptional item	-	(12.5)
Changes in working capital:		
Increase in inventories	(0.6)	(0.1)
Increase in trade and other receivables	(9.1)	(15.9)
Increase/(decrease) in trade and other payables	(7.6)	6.4
Decrease/(increase) in retirement benefit obligations	1.8	0.6
Decrease in provisions	(0.8)	(0.5)
Cash generated from operations	<u>313.7</u>	<u>307.4</u>

31. Net borrowings

	2014	2013
	£m	£m
Cash and cash deposits	315.8	234.4
<i>Borrowings - current</i>		
Other current borrowings	(31.1)	(21.1)
Finance lease obligations	(111.4)	(32.3)
Total current borrowings	<u>(142.5)</u>	<u>(53.4)</u>
<i>Borrowings – non-current</i>		
Other non-current borrowings	(690.8)	(590.2)
Finance lease obligations	(1,128.2)	(1,191.2)
Total non-current borrowings	<u>(1,819.0)</u>	<u>(1,781.4)</u>
Total net borrowings	<u>(1,645.7)</u>	<u>(1,600.4)</u>

NOTES TO THE FINANCIAL STATEMENTS

32. Operating lease commitments

	2014 £m	2013 £m
The future aggregate minimum lease payments under non-cancellable operating leases are:		
Within 1 year	1.5	1.4
Over 1 year and less than 5 years	5.4	5.1
Over 5 years	20.2	20.3
	<u>27.1</u>	<u>26.8</u>

33. Contingent liabilities

	2014 £m	2013 £m
Guarantee of borrowings of subsidiary undertaking	<u>377.5</u>	<u>371.0</u>

Guarantees in respect of performance bonds are entered into in the normal course of business. No liability is expected to arise in respect of the guarantees.

Other contingent liabilities relate to a possible obligation to pay further consideration in respect of a previously acquired business when the outcome of planning applications is known.

The company is subject to litigation from time to time as a result of its activities. The company establishes provisions in connection with litigation where it has a present legal or constructive obligation as a result of past events and where it is more likely than not an outflow of resources will be required to settle the obligation and the amount can be reliably estimated.

34. Capital commitments

	2014 £m	2013 £m
Contracted but not provided	<u>77.7</u>	<u>98.0</u>

35. Related party transactions

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

<u>Parent company</u>	2014	2013
	£m	£m
Purchase of goods and services		
-Group expenses	4.2	3.5
Sale of goods and services		
-Administrative services	0.5	0.5
Dividends paid	112.0	133.0
<u>Subsidiaries of the Company</u>	2014	2013
	£m	£m
Purchase of goods and services		
-Property consultancy	0.5	0.2
-Billing and collection services	9.3	8.8
Payment for provision of finance		
-Loan interest	15.2	16.6
-Finance lease charges: vehicles	0.1	0.1
Sale of goods and services (administrative services)	1.5	1.5
<u>Fellow subsidiaries of the Pennon Group</u>	2014	2013
	£m	£m
Purchase of goods and services		
-Waste disposal	-	0.5
-Insurance premia	0.3	0.3
Sale of goods and services		
-Tankered waste and trade effluent charges	0.6	0.7
<u>Year end balances</u>	2014	2013
	£m	£m
Borrowings		
-Loan from subsidiary	386.5	379.8
-Finance lease balances with subsidiary	0.7	0.7
Receivables		
-Subsidiaries	0.8	1.1
-Fellow subsidiaries	1.2	1.2
Payables		
-Parent company	1.2	0.7
-Subsidiaries	3.2	3.2

36. Parent Company

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