

COMPANY NO: 02366665

SOUTH WEST WATER LIMITED

ANNUAL REPORT AND FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 MARCH 2016

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CHAIRMAN'S STATEMENT

In my first annual statement as Chairman of both South West Water Limited and Pennon Group Plc I am pleased to announce that South West Water is in a strong position implementing its business plan for the K6 period (2015-2020) which received enhanced status from the regulator (Ofwat).

Since my appointment as Pennon Group Chairman on 1 August 2015, I have been impressed by South West Water's ability to deliver an efficient water and wastewater service and its focus on further improving operational quality. This efficiency and focus on improvement is driven by the talented individuals working at South West Water and those within the wider Pennon Group.

I believe the Company has the potential to maintain its position at the forefront of the industry in respect of cost efficiency while making continued improvements to customer service as well as strengthening and growing the wholesale business. The merger of South West Water and Bournemouth Water from 1 April 2016 will help deliver all of these aspirations.

2015/16 PERFORMANCE SUMMARY

South West Water has made a strong start to the first year of the K6 business plan with leakage levels on target, a 19th year without water restrictions, a 14% reduction in customer contacts regarding taste, odour or discolouration issues, improvements in bathing water quality in line with tougher EU standards and continued delivery of excellent quality drinking water.

This positive performance is underpinned by significant investment in both the drinking water and waste water networks such as the commencement of the plans for the Mayflower drinking water treatment works in the north of Plymouth and a targeted programme of wastewater treatment works improvements.

There are areas where focus is required to further improve South West Water's performance. In particular, strategies are being developed to prevent and mitigate the impact of drinking water supply interruptions where the average duration of interruption per property increased in 2015/16. A strategy is also being implemented to improve the robustness of the wastewater network and assets with the aim of reducing the number of 'serious' pollution incidents.

HEALTH AND SAFETY

I have been impressed by the level of commitment of the Board and the senior management team to the health, safety and wellbeing of our people. South West Water has strategic improvement plans in place and continues to invest in programmes and initiatives to further embed the change in culture and attitudes necessary to achieve its target of zero accidents and incidents.

FINANCIAL PERFORMANCE

South West Water's financial performance remained resilient despite significant tariff reductions given to our customers in line with the K6 business plan resulting in a reduction in revenue of 3.3% to £506.4m. Positively, operating costs decreased despite costs of growth, and average RPI inflation of 1.1%. Profit before tax and non-underlying items reduced by 4.9% to £159.6m.

South West Water continues to invest heavily in its asset base in line with its business plan as well as customer, Ofwat, Drinking Water Inspectorate and Environment Agency expectations. The Company invested £126.3m in capital asset additions during the year.

In line with South West Water's business plan dividends of £74.9m (49.6p per share) were paid during the year.

BOURNEMOUTH WATER

Plans to acquire Bournemouth Water and merge it with South West Water were given unconditional clearance by the Competition and Markets Authority (CMA) in November 2015. The companies were merged on 1 April 2016 and the integration process has been progressing well with a new management structure in place.

Bournemouth Water is a high-performing water-only company with an impressive track record of customer service. £27m of synergies are set to be achieved during K6 (2015-20), the synergies will be achieved through a combination of:

- the merging of the two companies' wholesale and retail operations
- the creation of a single, centralised support function
- the sharing of best practice to form common systems and processes
- supply chain efficiencies.

SUSTAINABILITY

Environment, social and governance (ESG) matters are integral to our strategy and business model and the Sustainability Committee continues to oversee our performance in maintaining a responsible approach to business operations. Notable achievements include another year of high quality drinking water, excellent performance against new EU bathing water standards, preliminary work on the cutting edge Mayflower drinking water treatment works for the Plymouth area, investment in further customer service improvements, further work to reduce the risk of sewer flooding, recognition for our apprenticeship programme and community engagement activities.

Further information on the Company's approach to sustainability is provided throughout the strategic report and in the Sustainability Committee report for the year on pages 52 to 55.

NEW GOVERNANCE FRAMEWORK

On my appointment as Chairman of both South West Water and Pennon I was pleased to see that a strong commitment to the three essential pillars of a successful Board – strong financial control, sound administration and good governance – was in evidence in the boardroom. I have reviewed the Group's Board structures having consulted with the Board's Non-executive Directors. As a result in December 2015, we announced the promotion of Chris Loughlin, who was at the time the Chief Executive of South West Water, to the position of Group Chief Executive Officer, effective from 1 January 2016. Chris is now responsible for the oversight and development of Pennon's strategy whilst driving greater synergies, encouraging the sharing of best practice and looking at growth opportunities across the Group.

I am delighted that Dr Stephen Bird was promoted to the post of Managing Director of South West Water on 1 January 2016. Stephen has extensive experience within the Company, most recently as Chief Operating Officer of Wholesale Operations and has also had a key role in South West Water's continued improved operational performance.

Following these appointments, we identified opportunities for streamlining the Group's governance framework and decision-making processes and fully implemented changes following the year end with agreement from Ofwat. This has included simplifying South West Water's Board structure to achieve more efficient governance, whilst preserving the regulatory ringfence around South West Water. Further details are provided in the Governance report on pages 37 to 43.

OTHER BOARD DEVELOPMENTS

On 17 February 2016 Monica Read resigned as a statutory Director of South West Water following her appointment as a Director of Pennon Water Services. She remains part of the South West Water Executive Management Team.

Duncan Ingram resigned as a Non-executive Director of South West Water on 10 February 2016. Since the year end, on 1 April 2016 and following the review of the Pennon Group corporate structure, Martin Angle, Neil Cooper and Gill Rider, who are all existing Pennon Group Non-executive Directors, were appointed as Non-executive Directors of South West Water.

Steve Johnson resigned as a Non-executive Director of South West Water on 28 April 2016 following his appointment to a new external executive position.

Finally I welcome the appointment of Helen Barrett-Hague as Pennon Group General Counsel and Company Secretary on 25 March 2016.

DIVERSITY

The Board continues to promote equality and diversity in all areas, including gender and ethnicity. I am pleased to report continued increasing female representation across the Company's Senior Management. At Board level South West Water remains committed to increasing female representation, however the resignation of Monica Read as a South West Water statutory Director and structural changes to the Group have resulted in a reduction in the percentage of female Directors. The Pennon Group Board however has achieved in excess of 25% female representation.

More information on the Board's diversity policy can be found within the Nomination Committee's report, on pages 56 to 57.

OUTLOOK

South West Water has made a positive start to the K6 regulatory period and is well placed to outperform its business plan over the five years. I believe that the changes we are implementing to the Group's governance framework will improve governance and oversight and ensure South West Water is best placed to deliver outperformance of the business plan whilst developing our people, delivering strong customer service, protecting the environment and helping the communities in which we operate.

SOUTH WEST WATER'S BUSINESS MODEL

We manage our business to deliver value. Our business model is underpinned by our commitment to creating and maintaining a sustainable business.

WHAT WE DO AND WHAT IS INVOLVED

We abstract water from the environment:

- maintenance of dams, including upgrading spillways and leats
- maintenance and upgrades of pumps and other assets (e.g. pipework)
- generating renewable energy using hydropower technologies.

We clean it and make it safe to drink:

- maintaining existing treatment works
- improvements to the clean water treatment processes
- investment in technological advancements such as Granular Activated Carbon to improve efficiency.

We distribute it to our customers:

- ensuring that clean treated water reaches our customers at the same level of quality as when it leaves our treatment works
- ensuring reliability of supplies
- preventing leakage and bursts.

Our customers rely on the services we provide:

- ensuring customers get excellent service when they contact us
- ensuring billing and payment systems work smoothly
- making the most of new technologies and digital communications (e.g. website and mobile apps).

We collect wastewater:

- maintenance and upgrades of sewerage infrastructure (network and assets)
- investment to reduce flood risk and associated pollution incidents.

We treat it and return it to the environment:

- maintenance and improvement of wastewater treatment assets as well as wastewater pumping stations
- wastewater treatment improvements to protect bathing water and shellfish water quality
- biosolids recycling
- energy generation from treatment processes through Combined Heat and Power (CHP).

THE VALUE WE DELIVER

Strong Governance				
Operational				Financial
Water	Environment	Service	People/ Community	Finance & Economy
Reliable, clean and safe supplies	Environmentally sustainable actions and initiatives	Responsive to our customers' needs and priorities	Supporting our people and local communities	Resilient business and service

The value we deliver is for the benefit of:

- our customers
- shareholders and investors
- regulators and stakeholders
- our employees
- suppliers and contractors.

OPERATIONAL EXCELLENCE AT SOUTH WEST WATER

South West Water is focused on providing water and waste water services in the most efficient and sustainable way possible. Innovation, new technologies and the pioneering of a holistic approach to water and wastewater management are playing a key role in delivering service improvements and long-term value.

KEY FACTS

- 1.7m total population served
- 794,749 customers served
- 21 raw water reservoirs
- 15,300km of drinking water mains network
- 653 water treatment works which include 62 with ultraviolet (UV) treatment facilities
- 15,600km wastewater mains network
- 900 wastewater pumping stations
- 145 bathing waters and 24 shellfish waters

OUR PERFORMANCE AGAINST THE K6 REGULATORY CONTRACT (2015-2020)

South West Water has the highest potential rewards in the sector for K6. At 31 March 2016 the Company has delivered an 11.7% Return on Regulated Equity (RoRE)¹ arising from base, operational and financial returns. Of the 11.7%, 6.0% is the base return, 3.0%² reflects the difference between actual and assumed financing costs, 2.5% reflects Totex savings and efficiencies, and 0.2% reflects Outcome Delivery Incentives (ODIs) outperformance.

TOTEX OUTPERFORMANCE

South West Water is striving for ever greater efficiency in K6, building on a strong track record from K5. The company was deemed to be at the frontier of cost efficiency when it was awarded an enhanced Business Plan assessment with the largest element of potential operational outperformance over K6 coming from total expenditure (Totex) savings and efficiencies. South West Water is 'front-end-loading' efficiencies and savings to allow early and more certain delivery of outperformance. £53m of Totex savings³ have been delivered in 2015/16, despite costs of delivering growth. These Totex savings reflect changes in the timing of delivery from those planned in the determination.

ODI REWARDS

South West Water has 23 outcome delivery incentives (ODIs), including SIM, which have potential financial rewards or penalties. Incentives for performance are recognised in the year of delivery, whether the measure is recovered in period or as a regulatory true-up at the end of the period.

Operational performance for the year, which is covered in more detail below, has resulted in an ODI reward. Rewards were secured across bathing water quality, odour complaints and water restrictions. Improved performance is being targeted in areas where penalties were received such as pollutions and interruptions to supply. ODI rewards result in a £1.9m benefit and reflects RoRE outperformance of 0.2%.

¹ RoRE reflects the Ofwat regulatory guidance of Base RoRE + Outperformance. It is calculated using actual results (deflated into 2012/13 prices) and compared against the Final Determination allowances sourced from Ofwat published models and based on notional gearing and annual average RCV.

² Interest outperformance is based on the outturn effective interest rate (adjusted for Regulatory Accounting Guidelines and one-off credits) adjusted by the RPI assumed within the Final Determination of 2.8%. Notional debt gearing of 62.5% and notional tax impact of 20%.

³ Phasing of actual expenditure compared to the planned programme has been reflected. Outperformance includes a reduction in the RCV run-off for the RCV element of Totex outperformance calculated based on the Final Determination PAYG. Tax impacts reflect actual effective tax rates of 10.6%.

WATERSHARE

South West Water has in place a unique WaterShare mechanism to share net benefits with customers through reinvestment options, future bill reductions and service improvements exceeding planned targets.

WaterShare reflects the established mechanism for sharing Totex outperformance but also allows customers to share in financing outperformance⁴ from movements in the market on new debt instruments. In addition specific items are also shared with customers – with differing rates depending on the Company delivery.

This WaterShare mechanism has identified c.£3.1m of benefits to customers this year and following discussions with our independent WaterShare panel it has been decided that this would be earmarked for reinvestment, rather than a targeted reduction in customer bills. This equates to a 0.3% Return on Regulated Equity (RoRE).

DRINKING WATER

South West Water continued to deliver high quality drinking water in 2015/16, achieving 99.97% Mean Zonal Compliance (the recognised industry measure for overall drinking water quality) for the calendar year 2015, a slight increase on the previous year (2014: 99.96%).

Leakage was kept within target levels, water resources were unrestricted for a 19th consecutive year and there was a 14% reduction in customer contacts regarding taste, odour or discolouration issues.

The average duration of supply interruptions per property, regrettably was up by 2 minutes to 25 minutes in 2015/16. This was largely due to two large trunk main bursts affecting customers' supplies; at St Blazey in Cornwall in October 2015 and Plymouth in December 2015. In each case South West Water took immediate steps to restore supplies as quickly as possible and keep customers informed.

Further strategies have been developed to prevent and mitigate the impact of such occurrences in future. These are being supported by the use of innovative techniques for network pressure management and monitoring, together with investment in advanced repair technologies.

Recognising that customers regard a clean and safe supply of drinking water as their top service priority, key areas of investment and activity during 2015/16 included:

- progressing plans for the state-of-the-art Mayflower drinking water treatment works in the north of Plymouth with a capital cost of c.£60m
- detailed design of improved water treatment processes such as Granular Activated Carbon (GAC) filtration and ultraviolet (UV) disinfection at five water treatment works across the region
- mains rehabilitation and flushing
- pressure management and network modelling
- investment in digital infrastructure, including improvements in retail customer engagement targeting a proactive and positive customer experience.

Furthermore, improved drinking water quality and drinking water treatment efficiency continue to be targeted through South West Water's award-winning 'Upstream Thinking' programme of catchment management.

Delivered in partnership with a range of stakeholder groups, including wildlife trusts and river authorities, Upstream Thinking's combination of moorland restoration initiatives and agricultural improvement schemes seeks to reduce the level of man-made and natural contaminants in the region's watercourses.

⁴ Financing outperformance is based on comparing average iBoxx rates, adjusted by notional Final Determination RPI of 2.8% and compared to the cost of debt assumed of 2.75%. This is applied to an assumed new debt level of 25% and adjusted for the tax impact.

Building on the programme's success in K5 (2010-2015), South West Water is investing around £10m between 2015 and 2020 to deliver improvements in 11 additional catchment areas. This will include 700 farm improvement schemes and the restoration of c.1,300 hectares of moorland.

WASTEWATER

South West Water aims to ensure the safe and efficient removal and disposal of wastewater while minimising the likelihood of sewer flooding or pollution affecting homes, businesses or the environment.

During K5 (2010-15) the Company focused on a targeted programme of wastewater treatment improvements while also working to prevent potential failure through increased monitoring. In 2015 its score for numeric compliance (the percentage of wastewater treatment works deemed compliant) at 95.8% remained above the K5 average but was slightly below that of the previous year (2014: 96.1%). This highlights the need for further enhancements as South West Water strives to achieve 100% compliance by 2020.

The Company's legacy of major investment to protect bathing waters, in addition to accelerated bathing water quality schemes implemented during 2014/15, was reflected in extremely positive results for the 2015 bathing water season, which was assessed under tougher new EU standards. Of the 145 bathing waters in the South West Water region tested, 141 (97.2%) passed with more than 70% classified as 'excellent'.

Four bathing waters were rated as 'poor' however this was not attributed to any failure of South West Water's assets. The Company recognises that bathing water quality is dependent on a wide range of factors and work continues, alongside partners including local councils, community groups, landowners and conservationists, to tackle bathing water quality issues in a holistic and sustainable way.

South West Water had zero 'serious' (Category 1) pollution incidents and made a substantial reduction in the number of pollution incidents overall (Category 1 – 4). However, there were seven 'significant' (Category 2) incidents compared with three in 2014.

A comprehensive performance review was undertaken which identified blockages on the network as the largest pollution risk. To improve the robustness of the wastewater network and assets, a strategy is now being implemented to increase monitoring and maintenance. The Company also continues to raise customer awareness about sewer misuse.

These improvements will also help to reduce the risk of sewer flooding. While the annual level of rainfall was relatively normal for the year, the number of internal and external sewer floodings was higher than the previous year as a result of extended periods of heavy rainfall in the winter of 2015/16.

In addition to capital maintenance and improvement schemes, South West Water is working to improve its response times to flooding incidents. In the longer term, a reduction in sewer flooding is also being sought through the Company's 'Downstream Thinking' programme of work to improve urban drainage using low-cost sustainable techniques including landscaping and sustainable drainage systems (SuDS).

In 2015/16 this included:

- Aveton Gifford, Devon – tackling sewer flooding in a joint project alongside the parish council, the school, the county council and householders to reduce the amount of surface water entering combined sewers
- Exmouth, Devon – locations have been identified where SuDS would be most beneficial. Community engagement and initial designs are planned for 2016/17
- Kingsbridge, Devon – the development of an Integrated Urban Drainage model in partnership with the Environment Agency and Devon County Council.

Furthermore, South West Water continues to work with organisations including the Environment Agency and local councils on flood alleviation projects. In 2015/16 this included the completion of a £2m scheme to protect homes in the Colebrook area of Plymouth and support for the proposed Environment Agency and Cornwall Council led £20m flood alleviation and regeneration scheme around St Austell (for which a funding bid has been submitted to the EU). South West Water is also providing financial support for the Exeter Flood Defence scheme.

CUSTOMERS AND COMMUNITIES

South West Water aims to be a good neighbour, and consults with its customers and stakeholders in order to understand and respond to their priorities. We aspire to have a positive effect on quality of life, communities and the regional economy.

SOUTH WEST WATER'S CUSTOMER STRATEGY

Central to South West Water's strategy is the management of the Company as a sustainable and successful business for the benefit of all of its stakeholders. South West Water recognises that consultation with its customers is imperative in order to understand their priorities and deliver the level of responsiveness that they require. In turn, this helps South West Water to build a solid reputation for high quality customer service, which contributes to the creation of shareholder value.

South West Water's customer strategy will be realised through delivery of its Business Plan to 2020, which places customer priorities at the heart of all its services and activities, aiming to deal with customer requests, problems and queries quickly and efficiently, and ensuring that the service provided represents value for money for all customers, whether residential or business.

CUSTOMER SATISFACTION

South West Water's overall customer satisfaction was broadly stable at 89% (2014/15: 90%), with satisfaction regarding value for money improving to 59% (2014/15: 58%).

A key indicator of customer service performance is the Service Incentive Mechanism (SIM), which Ofwat uses to compare the performance of water companies. The SIM score is calculated against a qualitative element (based on a customer survey) and a numerical element that takes into account amongst other things the number of complaints received in writing or by phone. South West Water's SIM score for the year was 78.6 (2014/15: 74.8), continuing the improving trend of recent years, but remains below the industry average.

Further improvements in customer service are being targeted through increased use of analytics, investment in staff training and the sharing of best practice following the merger of South West Water and Bournemouth Water.

RESPONSIVE TO CUSTOMERS' NEEDS

Household customers expect to be able to have a choice of communication methods through which queries can be raised and they expect their issues to be resolved on the first contact and as quickly as possible. In order to meet this expectation, South West Water's approach is focusing on local recruitment, training and employee development, and enhancing and promoting the services offered online.

The company has seen an improvement in the first time of contacts from customers during the year, reflecting both operational improvements and ongoing work to improve customer service through the proactive delivery of information, advice and support. This includes the availability of self-service options and real time information through digital platforms such as MyAccount, WaterLive and BeachLive. A revamped web presence is also in development for 2016/17.

SUPPORT FOR THOSE WHO NEED IT

South West Water has implemented a range of innovative industry-leading schemes to assist those customers with affordability or debt issues, such as its WaterCare+ scheme and initiatives delivered in partnership with Citizens Advice.

The Company was one of the first water companies to introduce a social tariff to ease pressures on very low income customers and to introduce the FreshStart grant scheme to assist those new to debt as a result of a downturn in their personal circumstances, such as bereavement or long term illness.

Through partnerships with social housing providers, South West Water is providing affordability help and advice to residents in order to build positive customer relationships and reduce debt. During 2015/16, this included targeted work with Teign Housing and North Devon Homes which resulted in an increased uptake of affordability schemes, increased metering and customer debt reduction.

METERING

South West Water continues to promote the benefits of metering to their customers, including water efficiency, the identification of leaks and the savings that can be made. 80% of South West Water's customers (household and non-household customers) are now metered (2014/15: 79%) with 6,058 installations carried out over the past year for customers switching to metering..

NON-HOUSEHOLD RETAIL STRATEGY

Preparations are being made to maximise the opportunities presented by the opening of the non-household retail market in 2017 while continuing to improve the services provided to business and commercial customers.

A separate legal entity has been created, Pennon Water Services (PWS), (a fellow subsidiary company of Pennon Group Plc) which operates from Bournemouth. This company will provide retail and water management services to the c.85,000 non-household customers. A key part of the non-household strategy will be to capitalise on Viridor's (a fellow Pennon Group subsidiary company) national footprint, focusing on existing customer relationships and exploring the opportunities to provide value-added services.

COMMUNITY RELATIONS STRATEGY

South West Water's aim is to ensure that all business activities have a positive impact on the communities in which we operate. With 29 water and 653 wastewater treatment works, it is important that the highest operational standards are maintained, community expectations are met and clear community benefits in our service areas are delivered. This is achieved by:

- undertaking activities in a way that minimises potential adverse effects on society, the environment and on those living or working in proximity to the Company's sites
- ensuring a positive economic impact on the local economy through the provision of essential services, employment and supply chain opportunities
- conducting open and transparent engagement with local communities and taking into account their needs and priorities
- making community investments that create benefits for both the community and the Company
- fostering an environment that encourages employees to engage with communities and provides opportunities for establishing partnerships with community organisations.

South West Water is focusing on strengthening its profile within the communities it serves, creating opportunities for employee engagement and developing long-term collaborations with charity and sponsorship partners, including the Royal National Lifeboat Institution, the Devon and Cornwall Food Association, the Devon Wildlife Trust and the South West Coast Path Association.

In 2016 South West Water received 2.5 stars out of five in the Business in the Community's 2016 Corporate Responsibility (CR) Index. This is a rigorous and robust benchmarking tool which has helped hundreds of companies measure and manage the progress they are making to integrate responsible business practice into their mainstream business at all levels. During 2015/16, South West Water provided a total of £136,250 in community support, sponsorship and charitable donations.

RECREATION AND LEISURE

The recreational opportunities and facilities available at South West Water's reservoirs are managed on its behalf by the South West Lakes Trust. Sailing, fishing, windsurfing, wakeboarding, nature trails and cycling are just a few of the activities the trust helps to facilitate. A highlight for 2015/16 was the achievement of a Green Tourism Gold Award for Wimbleball Lake in December 2015, recognising the trust's work to promote sustainable tourism.

CUSTOMER CAMPAIGNS

South West Water strives to engage, educate and inform residents and businesses about water usage and sewer blockages.

In August 2015, South West Water launched its 'Love Your Loo' community engagement campaign aimed at reducing sewer blockages and sewer flooding incidences. The campaign began in Falmouth, where the local public toilets received the 'red carpet' treatment in an attempt to engage local residents and visitors to the area.

EMPLOYEE VOLUNTEERING

South West Water has an active volunteering programme which enables staff to take part in agreed community projects including beach cleans and habitat restoration. These are often linked with external groups, such as Keep Britain Tidy and the region's wildlife trusts. In 2015/16 the volunteering programme included tree-planting and woodland expansion at Park Lake, a designated County Wildlife Site in North Cornwall.

SUPPORT FOR EDUCATION

To promote environmental sustainability and increase the level of understanding about the water sector, South West Water is actively engaged with schools, colleges and universities. It provides educational resources and activities ranging from school talks to work experience placements and site visits.

SKILLS FOR THE FUTURE

South West Water is a leading partner, together with the University of Exeter, South Devon College and others, in the development of a new University Technical College (UTC) for South Devon, based in Newton Abbot. The college, which opened in October 2015, places a unique focus on engineering, water and the environment and caters for up to 600 young people aged between 14 and 18.

Students will achieve academic and technical qualifications, enabling them to progress to positions as technicians or apprentices, and graduate engineers, thereby making a valued and sustainable contribution to the industry and the region.

REGIONAL ECONOMIC IMPACT

As an essential service provider, a significant employer and user of third party services, South West Water has a major economic impact on its region. The Company works with Local Enterprise Partnerships (LEPs) and is actively involved with European Structural Fund and Rural Development Programme Monitoring Committees to support economic growth, resilience and afford match funding opportunities for delivery partners.

South West Water also works with partners to maximise funding opportunities on behalf of the communities it serves. Alongside Cornwall Council and the Environment Agency, the Company is part of a bid to secure European Union funding for a £20m flood defence scheme in South East Cornwall.

ENVIRONMENTAL PROTECTION

As a business within which the environment is so closely correlated with its core activities, South West Water is acutely aware of its environmental impact and obligations. We understand that the scale of our operations brings with it a scale of responsibility in how we manage our workforce and operational activities, and we are committed to working in the most environmentally sustainable way possible.

SOUTH WEST WATER'S ENVIRONMENTAL STRATEGY

South West Water is committed to the conservation and enhancement of the natural environment. The Company's strategy involves applying best practice and targeting innovation to ensure the sustainability of its activities, maximising the efficiency of its use of resources, reducing waste and fully exploiting opportunities for renewable energy generation.

The Company is focused not only on meeting environmental standards but also the drive to find new ways of working that deliver better environmental outcomes. Rigorous steps are taken to protect the environment during the extraction, treatment and delivery of drinking water and the removal and safe disposal of wastewater (See the 'Operational Excellence' section - pages 7 to 10).

GREENHOUSE GAS EMISSIONS

South West Water continues to improve the way it manages energy and greenhouse gas emission levels through a combination of improving the efficiency of plants and pumps, encouraging greater water efficiency (reduced demand results in less water to be pumped around the network), the use of new technologies (such as remote operating systems) and renewable energy generation.

In 2015/16 South West Water focused on improved energy management through enhanced monitoring and performance tracking systems, including preliminary work to deploy sub-metering at its larger sites. The company sourced its largest volume of renewable energy of any year to date (24.3GWh which equates to c.9.3% of total energy usage) and increased its installed renewable energy capacity to 15MW. Staff engagement continued through the Company's Powerdown initiative which focuses on the 20% of South West Waters energy consumption which comes from process treatment and non-operational activities, for example; UV, process control, heating, lighting, cooling and PC usage.

South West Water reduced its carbon emissions to 158,891 tonnes of carbon dioxide equivalent (tCO₂e) (2014/15 166,370 tCO₂e). In April 2015 a hydro-electric scheme at Burrator Dam was brought online; a 160kW turbine generating c.250MWh per annum. In December 2015 South West Water also commissioned its largest on-site solar photovoltaic (PV) scheme to date; a 250kW array, generating 270MWh per annum for Camborne wastewater treatment works (around 12% of the site's total annual usage).

South West Water also commissioned its first collaborative community renewable energy scheme; a 100kW solar array supplying Nanstallon wastewater treatment works via a private wire supply and 20 year Power Purchase Agreement (PPA) with Wadebridge Renewable Energy Network (WREN).

Looking ahead South West Water has committed to buying power from Viridor (also a subsidiary of Pennon Group Plc), via its electricity supplier Total Gas & Power. This increases the renewable energy volume into the business. The Company is also investigating additional private wire renewable energy opportunities with developers and community groups across the South West region.

SITES OF SPECIAL SCIENTIFIC INTEREST (SSSIs)

There are nine SSSIs in the South West Water region. South West Water is the only water and wastewater company to meet the 2010 targets for SSSI land condition with 95% of total area to be classed as 'favourable or recovering'. The Company is now working to bring all of its land with SSSI designation to 'favourable' status by 2020.

NON-NATIVE INVASIVE SPECIES

In order to protect native biodiversity and ecosystems, South West Water monitors, reports and assesses the extent and potential impact of non-native invasive species on its sites and removes them as appropriate. South West Water also works to protect any known protected species on its sites.

RESTORATION OF PARK LAKE

Park Lake, a former china clay pit on Bodmin Moor, has been transformed by South West Water from a 'moonscape of waste sand and mica' to a designated County Wildlife Site and home to rare plants and animals.

Park Pit was turned into a reservoir by South West Water after the company entered into an agreement with the former owners, Imerys, to manage the surrounding land as an exemplar of post-industrial restoration. Planning conditions were met by 2012 but South West Water, working in partnership with local environmental groups and volunteers, has continued with an integrated management programme of restoration.

Work has included restoration of wetlands, control of invasive species and the introduction of managed grazing which has led to it being described by local conservationists as one of the best sites on Bodmin Moor for wildlife. It is now home to the second largest colony of the tormentil mining bee in Cornwall, breeding populations of the nationally scarce small red damselfly, 15 species of dragonfly including the keeled skimmer and black darter and the marsh fritillary butterfly, making it a nationally important site for conservation.

WORKPLACE

The most important element for the delivery of South West Water's strategic objectives is our people. The goal is to attract, nurture and retain a dedicated, highly trained workforce.

South West Water relies on the talent and professionalism of its employees and is committed to their health, safety and wellbeing, which it sees as investment in the Company's long-term human capital and directly related to the Company's value. The Company aims to develop and motivate employees, treat them fairly and ensure they are fully engaged in all aspects of the Company's objectives. This approach seeks to maintain a pipeline of talent that is well placed to lead and serve the business as it grows and adapts.

South West Water is committed to employee engagement, training and development, and equality and diversity, and provides ongoing support through a range of workplace policies. These cover areas such as health and safety, equal opportunities, ethics, employee relations and family friendly policies such as flexible working and parental leave, and schemes designed to promote the health and wellbeing of employees.

HEALTH AND SAFETY

South West Water strives for the highest standards of health and safety in the workplace so as to minimise accidents, incidents and lost time. The Company is working hard to embed health and safety within the culture of the organisation, reduce risk and achieve zero incidents.

Performance in respect of RIDDOR (Reporting of Injuries, Diseases and Dangerous Occurrences Regulations 2013) reportable injuries was maintained at the same level during the calendar year 2015 as in 2014, with a total of seven reportable injuries, none of which involved a serious injury.

Following a major review of its operational sites during 2014/15, South West Water undertook a number of activities in 2015/16 to further reduce health and safety risks. This included the roll out of a Dynamic Risk Assessment training package, designed to help front-line operational personnel undertake advanced risk assessment.

South West Water made progress with its Lone Worker programme to further safeguard staff working alone. This includes the use of wearable hardware known as TWIG™ which can monitor body movement and raise alerts if patterns of movement synonymous with injury, trips or falls are detected. The Company explored the use of remote technologies including aerial drones to provide improved risk assessment and trialled face-to-face physiotherapy to help provide employees with timely treatment, reduce the risk of longer term injury and thereby minimise lost working time due to absence. Health, safety and wellbeing also continued to be promoted through a variety of internal campaigns including 'TAP' ('Think, Act, Prevent') and 'Hang on a Sec' which was focused on raising awareness within wastewater operations.

EMPLOYEE DEVELOPMENT

South West Water's 'People Strategy', which was rolled out in 2012/13, continues to foster a culture of support and motivation for staff. Various programmes are in place to encourage career development and the Company continues to review and expand these to ensure it has the right balance of skills for the years ahead.

In 2015/16 South West Water's employee development programme included:

- continuing the programme of skills-based training for operational staff (started in 2014/15)
- supporting over 120 first-line, middle and senior managers through three tiers of management development programmes (Managing for Success (M4S), STEP and LEAD 2020)
- continuing to grow and expand the Company's award-winning Apprenticeship programme (85 apprentices have been recruited to the apprenticeship programme since it started in 2011).

APPRENTICESHIPS

Apprenticeships provide a legacy for the skills and knowledge that are integral to the Company's core business. In 2015/16 South West Water recruited 21 new apprentices, taking the current total to 85 across all directorates. The Company received a number of accolades during the year including Large Employer (South West) at the National Apprenticeship Awards and the retention of its Top 100 Apprenticeship Employer status.

EMPLOYEE ENGAGEMENT

Engaged staff are critical to the success of the Company. Employees who are more engaged feel safer and are involved in fewer accidents at work, take fewer days off sick and receive more positive feedback from customers. Put simply, working to improve engagement is a key part of working to improve overall performance and sustainability.

South West Water undertakes employee surveys at regular intervals. South West Water's 2015 employee survey showed a 77% response rate, up 4% on the prior year. The Engagement Index remained at 74% (against a benchmark of 70%), with areas of focus including more communication on Company changes, more recognition of effort and the sharing of rationales for decision-making.

CONSULTATION AND SUPPORT

Director led briefing sessions and a formal consultation regarding the integration of Bournemouth Water commenced in January 2016. A comprehensive employee support programme was made available for those affected.

WORKPLACE DIVERSITY

South West Water is committed to providing equal opportunities and improving diversity within its workforce. In the South West, female participation in engineering, manufacturing and construction is around 5% (8% nationally). In retail, health and care services female representation is around 80% both locally and nationally. In South West Water 21% of the workforce is female, with gender more balanced than these benchmarks, other than in the craft and industrial group in which female ratios are very low at less than 1%. The Company is focusing on this as an area for improvement, in particular in operational and technical roles.

FINANCE AND ECONOMY

South West Water's profit before tax and non-underlying items decreased by £8.3m to £159.6m, reflecting the expected revenue reset but net of strong operational cost control and favourable interest charges.

REVENUE

As expected in the new regulatory period, a c.5% tariff reduction was given to customers and as a result revenue reduced by 3.3% to £506.4m.

An additional £3.5m of revenue was generated by c.7,700 new customer connections with existing customer demand broadly in line with last year.

80% of South West Water's customers are now benefitting from a metered supply, with 6,058 customers opting for a meter in 2015/16 (2014/15: 7,489).

OPERATING COSTS (before non-underlying items)

While the Retail Prices Index (RPI) rose on average by 1.1%, operating costs, including depreciation, fell by £6.8m (2.3%) to £291.4m, despite the impact of some specific 'one-off' costs.

The key movements were:

- lower doubtful debt charges
- lower depreciation and costs of capital schemes
- additional efficiencies delivered in the year

offset by:

- cost increases (including non-household market opening costs)
- other cost movements including lower property sales and increased costs from other sales activity

Driven by strong collections performance and working with customers to manage their debt, the bad debt charge fell as a percentage of revenue fell further to 1.5% (2014/15: 1.7%). Debts totalling £3.5m (2014/15: £17.7m) were written off against the provision during 2015/16, of which £1.2m related to personal and commercial bankruptcy and £1.1m related to our ReStart programme, a South West Water customer affordability initiative. The higher value in the prior year reflected a detailed review of customers who had moved properties and where debt had been outstanding for a number of years.

NET FINANCE COSTS

Net finance costs have reduced from the prior year at £55.4m (2014/15: £57.5m), predominantly reflecting the lower interest on RPI index-linked debt and reprofiling of lease interest. £1.4m of interest was capitalised on longer term capital schemes.

South West Water has access to overall interest rates that are amongst the lowest in the water industry with an effective rate of 3.1%. Interest cover for 2015/16 is both within the required levels for financial covenants and in line with expectations.

PROFIT BEFORE TAX

Profit before tax was £159.6m, a decrease of £8.3m (excluding the non-underlying item) from the prior year.

TAXATION

The current tax charge for 2015/16 of £15.7m (2014/15: £29.8m) included £10.5m credit of adjustments for prior year, (2014/15 : £3.2M) which includes an updated assessment of uncertain tax items following clarification from HM Revenue and Customs (HMRC) on complex tax legislation, primarily relating to the deductibility of relief claims for capital expenditure. A deferred tax credit of £21.3m (2014/15 : £8.0m) resulted in a net total tax position of a credit of £5.6m (2014/15: charge £37.8m).

The current corporation tax charge which is included within the tax charge, decreased by £14.1m on 2014/15. This reflects the decrease in profit reported, the decrease in corporation tax rate to 20% and adjustments to the tax charge in respect of prior periods.

Deferred tax for the year was a credit of £21.3m (2014/15: charge £8.0m). The credit primarily reflects the change in rate of UK corporation tax.

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.

NON-UNDERLYING ITEMS

Non-underlying items totalling a charge before tax of £5.2m have been recognised which represents a £5.2m charge for restructuring provisions. In addition there is a £1.0m current tax credit and a deferred tax credit of £26.8m relating to change in rate of corporation tax. The non-underlying items total a credit after tax of £22.6m and have no immediate cash impact.

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 regulatory 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 £74.9m were paid to the parent undertaking (2014/15: £255.8m), representing a base dividend of £55.6m and £19.3m of outperformance dividend based on cumulative performance for 2014/15.

The dividend was calculated with reference to the projections in the Ofwat 2014 Final Determination and the assumptions for 2015/16 included within the 2015-20 Business Plan.

CAPITAL INVESTMENT

Capital additions for the year were £126.3m, a decrease from £145.1m in 2014/15. The key areas of focus remain:

- improved drinking water quality
- ensuring a high level of bathing water quality
- delivering environmental improvements.

Investments during the year included:

- continued investment on the new innovative Mayflower water treatment works at North Plymouth
- investments in assets at wastewater treatment works to maintain compliance
- investments in sludge treatment assets ahead of innovative programmes aimed at energy generation
- expansion of the water and sewer networks through requisitions
- delivering additional capacity to meet growth requirements.

South West Water continues to deliver capital projects in line with Ofwat, Drinking Water Inspectorate and Environment Agency expectations.

LIQUIDITY AND DEBT PROFILE

The Company has a strong liquidity and funding position with £251.2m cash and deposits at 31 March 2016 (including £214.0m of restricted funds representing deposits with lessors against lease obligations). In addition the Company has £685m of undrawn facilities.

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 2016 the Company's loans and finance lease obligations totalled £2,044.5m. After the £251.2m held in cash this gives a net debt figure of £1,793.3m (a decrease of £24.2m during the year).

The Company's debt has a maturity of up to 41 years with a weighted 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 regulatory period (K6 2015-20). The Company also has £395.6m of debt index-linked to 2041-2057 at an overall real rate of 1.78%. As a result of these initiatives South West Water's cost of finance is amongst the lowest in the industry with an average interest rate for 2015/16 of 3.1%.

At 31 March 2016 the fair value of the Company's non-current borrowings was £1,791.2m (2015: £1,747.2m) which is less than its book value as detailed in note 20 to the financial statements. This reflects the benefit of securing interest rates below the current market rate.

CAPITAL STRUCTURE

Net debt decreased by £24.2m during the year, reaching a total of £1,793.3m. The decrease primarily reflects the capital spend net of strong operational cash flows in 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. At 31 March 2016 RCV equalled £2,997.3m, an increase of £69.3m (2.4%) in the year driven by planned capital investment and RPI at the year end. The RCV at 31 March 2015 was £2,928.0m.

South West Water's net debt to RCV has decreased to 60%, which compares to Ofwat's K6 target for efficient gearing of 62.5%.

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 and the Directors therefore believe that it is well placed to manage its business risks.

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.

TAXATION STRATEGY

Our tax strategy, as approved by the Board, is to fulfil our statutory obligations by the application of relevant tax legislation in a reasonable way, engaging in tax planning only when it is aligned with the commercial and economic activity of the Company. This is in line with the principles published by the Confederation of British Industry (CBI) in 2013. The Company engages with HMRC in an open and transparent way identifying potential areas of uncertainty on a timely basis. Due to the complexity of tax legislation, the Company and tax authorities may sometimes have differing opinions on the treatment of certain tax items. The Company manages this risk and accrues for areas of tax uncertainty in line with accounting standards requirements, where appropriate. The Board is regularly updated on tax matters and any tax implications of commercial activities are highlighted to the Board with the use of a risk matrix to assess the appropriateness of a proposal.

TAX CONTRIBUTION

The total current tax charge for the year was £15.7m. A reconciliation between the actual tax charge and the estimated charge at 20% is provided in Note 8 to the financial statements.

The Company made a net payment of £32.4m of UK corporation tax in the year (2014/15: £36.4m). 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 £32.8m 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
- business rates of £26.9m paid to local authorities. This is a direct cost and reduces profit before tax
- employment taxes of £9.5m including employees' Pay As You Earn (PAYE) and total National Insurance Contributions (NICs).
- Fuel Excise Duty of £0.9m related to transport costs. This reduces profit before tax
- Carbon Reduction Commitment (CRC) payment for the Company was £2.3m representing the commitment payments for carbon usage in 2015/16. This reduces profit before tax.

The corporation tax rate for 2015/16 used to calculate the current year's tax is 20% (2014/15: 21%).

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 2016 the Company's share of the pension schemes showed a deficit (before deferred tax) of £29.6m (2014/15 £41.5m), the decrease primarily reflecting an acceleration of deficit recovery payments totalling £18.3m, offsetting adverse movements in asset market conditions and continuing low bond rates used in the discounting of the schemes' liabilities.

South West Water's regular cash contributions to the schemes remain within Ofwat's Final Determination for the K6 period. During the year South West Water paid £18.3m of deficit recovery payments into the scheme.

The last actuarial valuation of the main scheme was as at 31 March 2013.

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.

ECONOMIC SUSTAINABILITY

South West Water is one of the largest companies in the region and the services we provide are essential for the region's economic sustainability. The major investment we have made to safeguard the environment protects key regional industries such as tourism, while our use of local contractors and suppliers creates a major economic ripple effect.

In all aspects of our activity we strive to be as efficient as possible, ensuring our services represent value for money and that we carry out our business in a responsible way.

SUSTAINABLE SUPPLY CHAIN

South West Water annually places approximately £100m of order value with companies which have a base in the region. The Company's procurement process sets standards for individual supplier's approaches to economic, financial and environmental sustainability and we take rigorous steps to ensure they meet strict criteria in this regard.

We operate a 'mixed economy' supply chain model which uses smaller specialist companies alongside larger strategic partners. A culture of innovation and the sharing of best practice is encouraged and celebrated.

Our supplier sustainability programme identifies and delivers environmental benefits in key tenders, records the greenhouse gas footprint of key and strategic suppliers and implements the Supplier Code of Conduct.

OUR SUPPLIER CODE OF CONDUCT – suppliers must:

ENVIRONMENT	<ul style="list-style-type: none"> • assess and manage key environmental risks • comply with environmental regulations • focus on waste reduction and recycling • measure their greenhouse gas footprint and target reductions • larger companies are expected to have formal environmental management systems accredited to ISO 14001.
ECONOMIC	<ul style="list-style-type: none"> • be financially sound • operate a sustainable cost model providing a fair wage for employees and a timely payment of suppliers • support an open book approach to cost, encouraging collaboration and driving sustainable cost reduction • maximise the benefit for the economy and employment in South West Water's region.
SOCIAL AND ETHICAL	<ul style="list-style-type: none"> • operate to the highest ethical standards • accept South West Water's Supplier Code of Conduct • comply with provisions of the Bribery Act 2010 • declare any personal interests • comply with international labour standards in accordance with the principles of the International Labour Organisation Conventions • support sustainable local communities in their areas of activity • adopt appropriate ethical standards for global trading (ETI, SA 8000, UN Global Compact).

RISK REPORT

The Company faces a number of risks which, if they arise, could affect its ability to achieve its strategic objectives. The Board is responsible for identifying principal risks and ensuring appropriate risk mitigation is in place to manage them effectively.

RISK MANAGEMENT FRAMEWORK

Successful management of existing and emerging risks is essential to the long term success of the Company and the achievement of its strategic objectives. South West Water operate a well established and fully embedded risk management framework from which we seek to identify significant risks at the earliest possible stage and determine whether they are being appropriately managed and mitigated.

The key stages of the risk process are:

- identification of significant risks by core business functions, utilising agreed risk criteria based on a combination of likelihood and impact considering each of financial, reputational, management effort, stakeholder and customer impacts
- principal and business risks are captured within the Company's Risk Register. This register includes a description of the risk, the related legislation and obligations, mitigations and controls which are in place, assessments of the scale of the risk before (gross risk) and after (net risk) mitigations and controls in place as well as an assessment of the Company's appetite to the risk (see below) as well as the direction of travel of the risk level. Where the post mitigation risk assessment is outside of the Company's appetite consideration of possible further actions to reduce the risk level is made
- quarterly risk and assurance forums are held to review both principal and business risks with management justifying their risk assessments through formal reports and presentations. These forums consider risks on a cyclical basis as well as when there are significant events or circumstances which have resulted in a risk significantly changing
- principal risks are reported on a quarterly basis through the executive management teams, before onward submission to the Pennon Group Plc Risk Forum for due consideration. The senior executive management team's role is to debate, challenge, agree and prioritise principal risks faced by the Company based on the Board's agreed risk appetite, before formal presentation to and approval by the directors of the Plenary Board and Audit Committee following a robust risk assessment.

RISK APPETITE

Risk appetite is defined as the level of risk it is considered appropriate to accept in achieving the Company's strategic objectives. The appropriateness of the mitigations applied to each principal risk is considered by the Board in the context of the effectiveness of the overall control environment in ensuring compliance with risk appetite.

ROBUST RISK ASSESSMENT

The Directors confirm that they have carried out a robust assessment of the risks facing the Company. The following table describes the principal risks, how they are being managed or mitigated in line with the Board's risk appetite. These principal risks have been considered in preparing the viability statement on pages 31 to 32.

Key	Increasing	Unchanged	Decreasing
Current assessment of direction of travel of risk			

LAW REGULATION AND FINANCE

Compliance with laws and regulation 	
<p>Commentary Legislative and regulatory compliance is at the core of the business and industry. In the regulated water industry companies are subject to numerous and changing obligations with which we must comply.</p> <p>Following South West Water's enhanced business plan status for 2015-20 there may be increased expectations upon South West Water.</p> <p>The performance for K6 (2015-20) is focused on the framework of customer outcomes and Outcome Delivery Incentives (ODIs). The ODIs cover a range of measures and include those, which have a financial penalty or reward for changes in performance.</p> <p>Performance against outcomes and ODIs for 2015-20 is also being considered as part of the 'WaterShare' mechanism.</p>	<p>Mitigation South West Water has significant mitigations in place to ensure compliance with legislation and regulation. The Company pays particular attention to the water industry specific obligations and changes to these obligations.</p> <p>Performance against ODIs is reported to the Board and a separate 'ODI Board' has been established which meets on a monthly basis and includes relevant Directors and senior managers.</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's financial and technical auditors to provide assurance on the Company's compliance with its obligations.</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> <p>Risk Appetite South West Water is a highly regulated industry and high standards of compliance are sought with a very low appetite for legal and regulatory breaches.</p>

Regulatory reform 	
<p>Commentary 2015/16 has been the first financial year of the new regulatory period (2015-20) (K6). South West Water's business plan for K6 obtained an 'enhanced' status.</p> <p>A key benefit of enhanced status has been sufficient certainty for the Company to implement the strategies for K6 earlier than may have otherwise been possible. Ofwat's programme of reform continues including a focus on key areas including:</p> <ul style="list-style-type: none"> • strategy and planning • delivering the reforms in the Water Act 2014, including the market arrangements for non-household retail • Water 2020, a programme looking at both regulatory and market reforms within the industry • compliance and assurance. 	<p>Mitigation South West Water is continuing with strong Board leadership and governance supported by an integrated risk and assurance framework, which is embedded into the Company as well as engagement at all levels with the regulator.</p> <p>Good progress has been made in preparing for regulatory reform. External reviews support the assurance letters required by the Market Operator. South West Water has fully engaged in the Water 2020 programme including upstream regulatory reform.</p> <p>Risk Appetite Recognising that Regulatory reform is inevitable South West Water will aim to minimise the impact of regulatory reform targeting changes which are on a net present value neutral basis over the longer term to protect shareholder value and customer affordability.</p>

Non-compliance with health and safety legislation or occurrence of avoidable health and safety incident 	
<p>Commentary South West Water is committed to achieving the appropriate level of health and safety compliance.</p> <p>The number of accidents reportable under RIDDOR (Reporting for Injuries, Diseases and Dangerous Occurrences Regulations) for 2015 remained at seven incidents (2014: seven).</p>	<p>Mitigation There are rigorous health and safety compliance systems, policies and procedures in place across South West Water.</p> <p>A significant review of operational sites has been undertaken to provide up to date risk assessments at all wastewater and drinking water treatment sites.</p> <p>A programme of capital investment has been delivered reducing site risks further.</p> <p>Senior management and Executive visits are completed during the year across a number of sites, and a focus on behavioural safety continues.</p> <p>Risk Appetite High standards of compliance are sought with no appetite for compliance breaches within South West Water and third party operations.</p>

Non-compliance with market codes and competition law. Loss of income following the non-household retail market opening in April 2017 	
<p>Commentary The 'Open Water' project is set to open the non-household retail market for water in England and Wales from 1 April 2017. This project has no direct impact on the household market.</p> <p>Compliance with market codes and competition law following market opening across both the wholesale and retail business is essential.</p> <p>Whilst the level of customer switching post 1 April 2017 is unknown there is a risk that retail income (and margin) could be lost.</p>	<p>Mitigation South West Water are making good progress in the preparedness for market reform through the internal 'MarketReady' programme which is ensuring South West Water will be ready for market opening and will be in a position to comply with market codes and with relevant competition law.</p> <p>An external assurance partner is providing the Board with assurance over the programme. South West Water are prepared for the official 'Shadow Operation' period which will begin on 1 October 2016.</p> <p>Following an extensive assurance exercise, South West Water issued an 'assurance letter' to Ofwat confirming that it has plans in place to be ready for market opening.</p> <p>The Non-household retail strategy is also well advanced and in advance of full market opening in England and Wales, South West Water's subsidiary Source for Business have been successful in obtaining retail non-household customers in Scotland, where the non-household retail market is already open.</p> <p>Risk Appetite To minimise the impact of market reform through defending existing customer base whilst developing further markets.</p>

Maintaining sufficient finance and funding to meet ongoing commitments 	
<p>Commentary South West Water requires long term borrowing in order to fund the Company's capital programme.</p> <p>The Company currently has a strong liquidity and funding position.</p> <p>The Company can be impacted by wider economic conditions and availability of finance from banks and other institutions.</p>	<p>Mitigation 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>There is clear treasury and funding policies in place and an effective Group Treasury team.</p> <p>Funding is in place at effective average interest rates below many in the sector, with prefunding and headroom, including revolving credit facilities, to meet future funding requirements.</p> <p>Risk Appetite Ensuring that funding requirements are fully met by maintaining prudent headroom.</p>

MARKET AND ECONOMIC CONDITIONS

Non-recovery of customer debt and affordability 	
<p>Commentary 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>Household customers within the South West Water region continue to receive a £50 contribution from the Government and this is currently committed by the Government until 2020.</p>	<p>Mitigation South West Water strategies are kept under review with initiatives implemented including:</p> <ul style="list-style-type: none"> • targeting previous occupier debt after customer moves • specific case management and use of court claims • use of charging orders to secure debt after customer moves • engaging collection agencies to perform <i>doorstep visits to customers with debts over one year old to arrange payment plans.</i> <p>South West Water was one of the first companies to implement a social tariff. The Company has also continued to fund and promote ways to help customers struggling to pay bills (WaterCare, ReStart, FreshStart Fund) which helps to reduce bad debt exposure.</p> <p>Risk Appetite To minimise non-recoverable debt but recognising customer affordability challenges and that domestic customers cannot be disconnected the risk of uncollectable debt remains.</p>

Poor operating performance due to extreme weather or climate change



Commentary

South West Water continues to experience extreme weather – which has in general seen more periods of consistently dry weather but offset with short bursts of extreme rain and some locally intense rainfall resulted in an increase level of storm flows into some wastewater treatment works and resultant discharges.

Pressures on water resources in summer and the operational impact of flooding and high winds in winter is therefore anticipated to increasingly test South West Water's assets.

Mitigation

South West Water is well placed to manage such extreme incidents and has already demonstrated its ability to minimise the impact of such events on customers. Detailed contingency plans, sufficient emergency resources and a capital programme that supports ongoing efforts to manage these risks are all in place.

We prepare a Water Resources Management Plan every five years and review it annually for a range of climate change and demand scenarios, with various schemes promoted to maintain water resources (e.g. pumped storage for reservoirs), conservation and customer water efficiency measures.

In the longer term the continued 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.

Risk Appetite

South West Water's appetite reflects the desire to reduce both likelihood and impact through long term planning and ensuring sufficient measures in place to mitigate this risk.

OPERATING PERFORMANCE

Poor service being provided to customers



Commentary

Customer service remains paramount to South West Water and the Company focuses on improving customer satisfaction and reducing customer complaints.

Continued year on year improvements have been achieved by South West Water as the Company aims to improve its position relative to the industry, which currently is towards the lower end of performance.

Mitigation

During the year targeted improvements have been made in order to increase the Company's customer service performance. Specific measures taken include:

- focus on resolving contacts first time
- enhancement of web offering, including the ability for customers to engage with staff in real time via Webchat
- proactive outbound SMS messaging around service disruption and also prior to issuing of reminders and refunds
- case managers appointed to resolve customer issues.

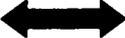
Further improvements planned include:

- increasing our outbound communications by being proactive to avoid unnecessary contacts
- increasing contacts resolved first time
- enhancing our Web Services to inform, track and answer customer enquiries 24 hours a day.

Risk Appetite

Good customer service is at the heart of South West Water with the aim of increasing customer service and customer satisfaction.

Significant operational failure or incident occurring 	
<p>Commentary Due to the nature of South West Water's business there are risks which arise during the normal course of business, including risk of failure of assets, processes or systems. These could include:</p> <ul style="list-style-type: none"> • water quality deterioration • contamination of water supplies • pollution and flooding events • water resource restrictions. <p>During 2015/16 South West Water did not experience any Category 1 pollution incidents, however there were seven Category 2 pollution incidents and further work is required to achieve South West Water's target of no Category 1 or 2 pollution incidents.</p>	<p>Mitigation South West Water has established and detailed procedures, contingency plans and incident management procedures.</p> <p>Equipment failure is managed through planned preventative maintenance regimes. Any disruption is alleviated by good liaison and communication.</p> <p>Risk Appetite Recognising the residual risk of incident or failure, effective business continuity and contingency plans are in place to mitigate the risk and accelerate the recovery from an incident with residual risk covered by insurance.</p>

Insufficient talent management or succession planning 	
<p>Commentary South West Water has implemented a range of succession plans at the senior levels but recognise that there remain challenges on recruiting the appropriate expertise (particularly in the Engineering and Scientific areas).</p>	<p>Mitigation South West Water has established a range of development programmes including:</p> <ul style="list-style-type: none"> • Lead 2020 – senior management programme • Managing for Success (M4S) – for first line managers • STEP – for managers and other staff • apprentice programme <p>Risk Appetite To ensure staff have appropriate skills and experience with good succession plans to mitigate the impact on our strategic priorities and plans.</p>

BUSINESS SYSTEMS AND CAPITAL INVESTMENT

Information technology systems, management and protection including cyber risks 	
<p>Commentary Recent security breaches across a range of industries highlights the growing risk of a sophisticated cyber-attack.</p>	<p>Mitigation Cyber risks are mitigated through:</p> <ul style="list-style-type: none"> • a strong information security framework and governance • penetration testing and vulnerability testing by external consultants • ISO accreditation • extensive training and demonstrations across the business. <p>Risk Appetite To ensure robust systems and security in place to support business activity with strong cyber protection to minimise a growing risk.</p>

Loss of key stakeholder support and prolonged negative media campaign 	
<p>Commentary 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>Mitigation The Company is committed to engaging with customers and key stakeholders, including managing communications via social media.</p> <p>South West Water's innovative 'WaterShare' mechanism (to share rewards of out-performance with customers) is overseen by an independent panel of key stakeholder representatives.</p> <p>Risk Appetite To engage with key stakeholders and media to ensure positive relationships which enhance South West Water's reputation.</p>

VIABILITY STATEMENT

The Board has assessed the Company's financial viability and confirms that it has a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over a five-year period. The assessment has been made with reference to the Company's current position and prospects, its longer-term strategy, the Board's risk appetite and the Company's principal risks and how these are managed, as detailed on pages 25 to 31 of the Risk Report.

The Company's strategic business plan and associated principal risks are a foundation of the scenario testing. This assessment has considered the potential impact of arising risks on the business model, future performance, solvency and liquidity over the period in question. In making their assessment, the Directors reviewed the principal risks and considered which risks might threaten viability. It was determined that none of the individual risks would in isolation compromise the Company's viability, so a number of plausible risk combinations were considered to stress test the plan, primarily by reducing revenues, increasing costs and impacting cash flows. The Board considered the monetary impact of these scenarios over a five-year period, to ensure that they did not adversely impact the Company's viability.

In making the assessment, the Directors have taken account of the Company's robust capital solvency position, its ability to raise new finance and a key potential mitigating action of restricting any non-contractual payments.

In assessing the prospects of the Company, the Directors note that as the Company operates in a regulated industry which potentially can be subject to non-market influences, such assessment is subject to uncertainty, the level of which depends on the proximity of the time horizon, and accordingly the future outcomes cannot be guaranteed or predicted with certainty

As set out in the Audit Committee's report on pages 44 to 51, the Directors reviewed and discussed the process undertaken by management, and also reviewed the results of the stress testing performed.

FORWARD-LOOKING STATEMENTS

This strategic report, consisting of pages 3 to 24, contains forward-looking statements regarding the financial position; results of operations; cash flows; 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 strategic report, 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 section on principal risks and uncertainties.

By Order of the Board



R C Zmuda

Secretary
Peninsula House
Rydon Lane
Exeter
Devon
EX2 7HR

27 May 2016

GOVERNANCE AND REMUNERATION

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SOUTH WEST WATER LIMITED BOARD OF DIRECTORS

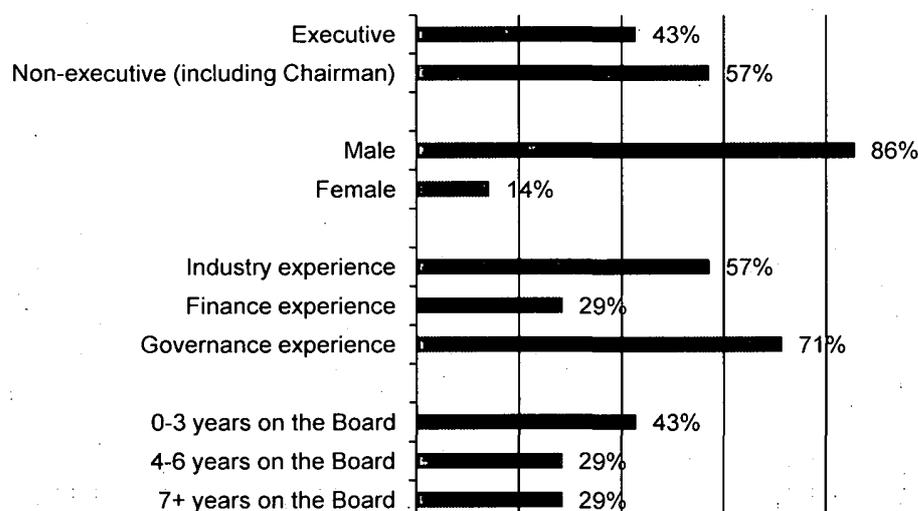
The South West Water Board of Directors at the end of the 2015/16 financial year comprised the Chairman (a Non-executive Director), three Executive Directors, and three further Non-executive Directors. Another three Non-executive Directors joined the Board on 1 April 2016. The Board considers the Non-executive Directors to be independent in accordance with the UK Corporate Governance Code. The Board believes its Directors have an appropriate range of skills and experience to oversee the business of the Company.

Name			
Sir John Parker	Chris Loughlin	Dr Stephen Bird	Louise Rowe
Position			
Chairman	Pennon Group Chief Executive	Managing Director	Finance Director
Date of appointment			
31 July 2015	1 August 2006	1 March 2000	1 February 2015
Experience			
<p>Sir John was appointed to the Board on 31 July 2015 and became Group Chairman on 1 August 2015.</p> <p>Sir John is recognised as a highly experienced and independent chairman and brings a wealth of leadership experience across a range of industries. He was previously the chairman of National Grid Plc, senior non-executive director and chair of the Court of the Bank of England, deputy chairman of DP World, joint chair of Mondi and chair of BVT and P&O Plc.</p> <p>Sir John is the chairman of Anglo American Plc. He is also a non-executive director of Carnival Corporation and Airbus Group. Sir John is a Visiting Fellow of the University of Oxford and was president of the Royal Academy of Engineering from 2011 to 2014.</p> <p>Sir John's significant commitments in the year have reduced with him stepping down as deputy Chairman of DP World in July 2015.</p>	<p>Chris was appointed as Chief Executive of South West Water in 2006. He became Pennon Group Chief Executive on 1 January 2016.</p> <p>Chris was previously chief operating officer with Lloyds Register and 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. Chris started his career as a chartered engineer working in both the consulting and contracting sectors and subsequently held a number of senior positions with British Nuclear Fuels. Between April 2008 and March 2012 he was chairman of Water UK.</p> <p>Currently Chris is vice-chairman of the Cornwall Local Enterprise Partnership and a trustee and member of the audit committee of WaterAid.</p>	<p>Prior to joining South West Water, Stephen held posts in the Welsh Water Authority, National Rivers Authority and Wallace Evans Consultants as an environmental consultant.</p> <p>Stephen is Director of the Heart of the South West Local Enterprise Partnership and a member of Water UK En PAG. He is a Fellow of the Chartered Institute of Environmental Managers, fellow of the Institute of Directors and holds an MBA.</p> <p>Stephen was appointed to the position of Managing Director of South West Water on 1 January 2016.</p>	<p>Louise has been with South West Water for over seven years, holding a range of managerial roles in the Finance Directorate prior to her appointment as Finance Director on 1 February 2015. She is a physics graduate and qualified as a chartered accountant with KPMG.</p> <p>Louise is a member of the Water UK Finance Directors Forum and in 2014/15 Louise was Chair of the Prince of Wales' Accounting for Sustainability's Natural and Social Capital Project.</p>

Name		
Martin Hagen	Steve Johnson	Lord Matthew Taylor
Position		
Non-executive Director	Non-executive Director (resigned 28 April 2016)	Non-executive Director
Date of appointment		
1 September 2010	1 September 2014	1 March 2010
Experience		
<p>Martin is an independent member of the Audit and Risk Assurance Committee of the Department for Work and Pensions (DWP), and Governor and Audit Committee Chair of the University of the West of England.</p> <p>He was previously Deputy Chairman of the Financial Conduct Authority's Regulatory Decisions Committee, a board member and President of the Institute of Chartered Accountants in England and Wales and senior partner of Deloitte's West of England practice.</p>	<p>Steve Johnson is Chief Executive of Electricity North West and former Chairman of the Energy Networks Association.</p> <p>He has considerable experience across the UK gas, electricity and water supply industries, and was Managing Director of Morrison Plc, the support services business.</p> <p>He is a member of the Institute of Engineering and Technology.</p>	<p>Lord Taylor of Goss Moor Chairs the St Austell Eco-Community Strategic Partnership Board. He has expertise in planning for sustainable communities. He was MP for Truro and St Austell for 23 years from 1987, until he stood down at the 2010 general election.</p> <p>Matthew is also Non-executive Director of Mayfield Market Towns Ltd., and Chair and Non-executive Director of Bridgehall Real Estate Limited and Kensa Heat Pumps Limited.</p>

Name		
Martin David Angle	Neil Cooper	Gill Rider
Position		
Non-executive Director	Non-executive Director	Non-executive Director
1 April 2016	1 April 2016	1 April 2016
Experience		
<p>Martin was appointed to the Pennon Group Plc Board on 1 December 2008.</p> <p>Formerly Martin had senior positions with Terra Firma Capital Partners and various of its portfolio companies, including the executive chairmanship of Waste Recycling Group Limited. Before that he was the group finance director of TI Group Plc having previously held a number of senior investment banking positions with SG Warburg & Co Ltd, Morgan Stanley and Dresdner Klienwort Benson.</p> <p>During the year, having completed his full terms of office, he retired from the boards of OAO Severstal, Shuaa capital psc and the National Exhibition Group where he was chairman.</p> <p>Martin is currently the senior independent director at Savills Plc, the vice chairman and non-executive director of the FIA Foundation, and the adviser to the board of the Commercial Bank of Dubai.</p>	<p>Neil joined the Pennon Group Plc Board on 1 September 2014.</p> <p>He was previously the group finance director of William Hill Plc and before that he was group finance director of Bovis Homes Group Plc. He also held senior financial roles with Whitbread Plc, worked for PwC as a management consultant and held a number of roles with Reckitt & Colman Plc.</p> <p>Neil is currently the chief financial officer of Barratt Developments Plc.</p>	<p>Gill was appointed to the Pennon Group Plc Board on 1 September 2012.</p> <p>Formerly Gill was head of the Civil Service Capability Group in the Cabinet Office reporting to the Cabinet Secretary and prior to that held a number of senior positions with Accenture LLP culminating in the post of chief leadership officer for the global firm. She was previously president of the Chartered Institute of Personnel & Development and a non-executive director of De La Rue Plc.</p> <p>She currently holds non-executive directorships with Charles Taylor Plc, where she is senior independent director, and Intertek Group Plc. She is chairman of both of their remuneration committees. She is also chair of the council (board) of the University of Southampton.</p>

BOARD COMPOSITION, DIVERSITY, EXPERIENCE AND TENURE (AS AT 31 MARCH 2016)



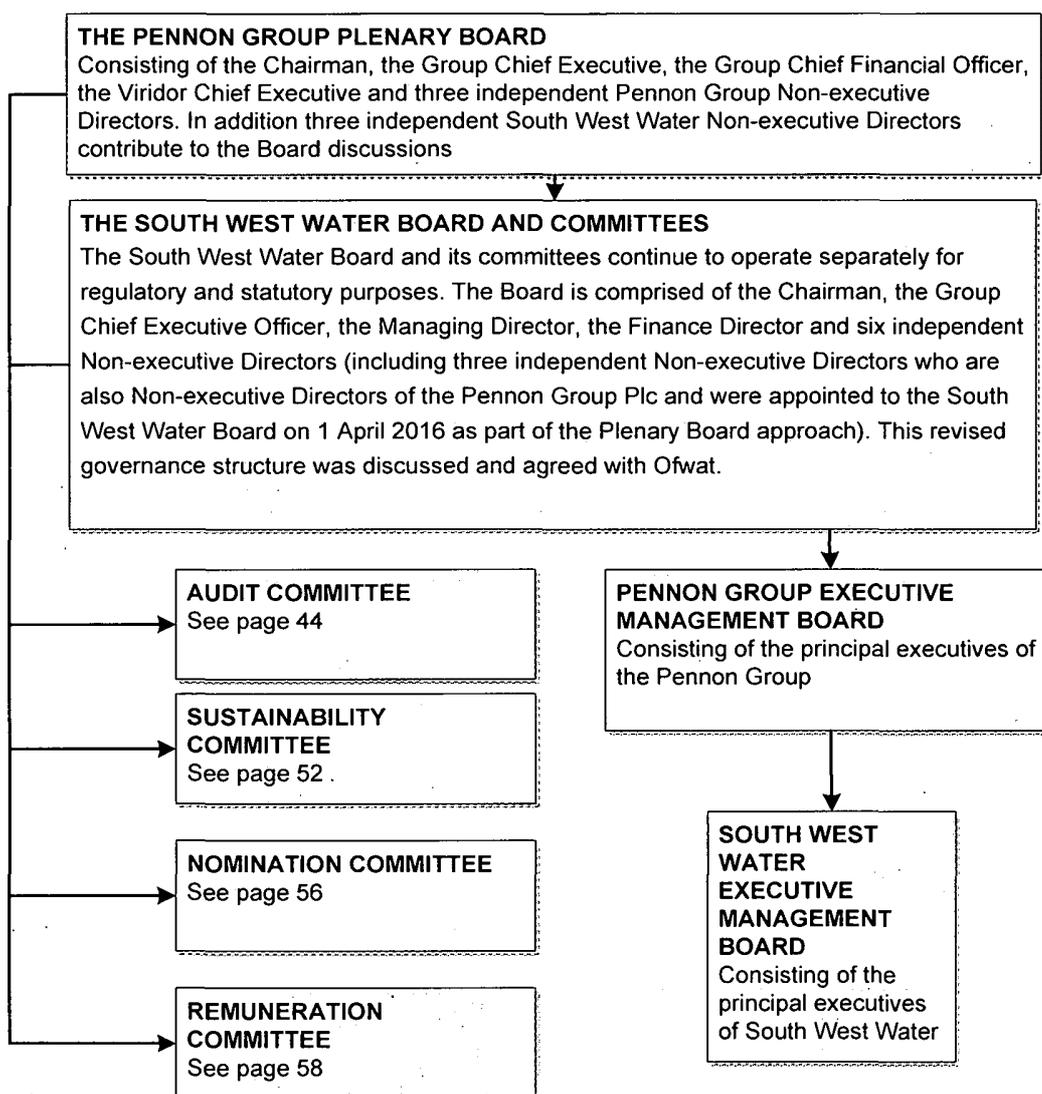
Whilst female representation on the Board reduced from 21% to 14% as at 31 March 2016, following Non-executive Director appointments made on 1 April 2016, 20% of the Board are now female.

THE BOARD AND ITS GOVERNANCE FRAMEWORK

GROUP STRUCTURE REVIEW

Following the appointment of Sir John Parker as Chairman of both South West Water Limited and of Pennon Group Plc, a review of the Group's structure was undertaken. On completion this resulted in a number of changes to governance processes within the Pennon Group and South West Water. The changes, which represent an important step for Pennon Group and South West Water as they look towards the future, aim to streamline the governance process simplifying it within South West Water, achieving more efficient and effective governance throughout the Pennon Group. The regulatory ring-fence around the South West Water business is being protected.

The new governance framework introduced from April 2016 incorporates a 'plenary' style of operation and is set out below. Each Board has a 'matters reserved' schedule setting out its responsibilities and each committee has detailed terms of reference setting out its responsibilities and accountabilities. Further details of the responsibilities of each of the Committees are set out in the report of each Committee on pages 44 to 58. These, together with the risk management and internal controls frameworks described on page 41, form an effective and robust governance structure.



South West Water's Risk and Assurance Forums (see page 25), chaired by the South West Water Finance Director, continue to report to the South West Water Executive Management Board.

BOARD ATTENDANCE, OPERATION AND ACTIVITIES

The Directors and their attendance at the 10 scheduled meetings of the Board during 2015/16 are as follows:

Board membership		Appointment date	Attendance ⁽⁶⁾
Chairman			
Sir John Parker ⁽¹⁾	Chairman	July 2015	7/7
Ken Harvey ⁽²⁾	Chairman	March 1997	3/3
Executive Directors			
Chris Loughlin	Pennon Group Chief Executive	August 2006	10/10
Dr Stephen Bird	Managing Director	March 2000	10/10
Louise Rowe	Finance Director	February 2015	10/10
Monica Read ⁽³⁾	Business Services and Sustainability Director	September 2002	8/8
Non-executive Directors			
Martin Hagen	Non-Executive Director	September 2013	9/10
Lord Matthew Taylor	Non-Executive Director	March 2013	10/10
Steve Johnson ⁽⁴⁾	Non-Executive Director	September 2014	10/10
Duncan Ingram ⁽⁵⁾	Non-Executive Director	September 2014	8/8

⁽¹⁾ Appointed as Group Chairman 1 August 2015

⁽²⁾ Resigned 31 July 2015

⁽³⁾ Resigned 17 February 2016

⁽⁴⁾ Resigned 28 April 2016

⁽⁵⁾ Resigned 10 February 2016

⁽⁶⁾ Attendance includes only meetings during the appointment of the Directors

In accordance with the governance framework the Board now operates as the Board of South West Water within the Pennon Plenary Board structure ensuring compliance with Ofwat's principles on Board leadership, transparency and governance.

The Board delegates more detailed consideration of certain matters to the Board Committees, to the Executive Directors and to the Company Secretary. The matters reserved to the Board include:

- approval of the full year and half-year results
- approval of the Annual Reports and Financial Statements and the Annual Performance Report and Regulatory Reporting
- all acquisitions and disposals
- major items of capital expenditure
- authority levels for other expenditure
- risk management process and the monitoring of risks
- approval of the strategic plan and annual operating budgets
- Company policies, procedures and delegations
- appointments to the Board and its Committees.

All Directors are equally accountable for the 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 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 Board Operates by receiving written reports circulated usually in advance of the meetings from the Executive Directors and the Company Secretary on matters within their respective business areas. Where appropriate, the Board also receives presentations on key areas of the business and undertakes site visits to gain a better understanding of the operation of business initiatives.

Under the guidance of the Chairman all matters before the Board are usually discussed openly and presentations and advice are received frequently from other senior executives within the Company and from external advisors to facilitate the decision making 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.

COMPANY AND GROUP COMPLIANCE WITH THE HIGHEST STANDARDS OF BOARD LEADERSHIP AND GOVERNANCE

South West Water Limited is a wholly-owned subsidiary of Pennon Group Plc, a FTSE 250 company with a premium listing on the Official List, trading on the main market for listed securities of the London Stock Exchange.

South West Water and its parent company, Pennon Group Plc, remain committed to operating to the highest standards of board leadership and governance including transparency of reporting to investors, customers, regulators and other stakeholders. The full range of South West Water's corporate issues including strategy, performance, delivery, compliance and governance are covered within the governance structure shown above.

In response to, and in accordance with Ofwat's 'Board leadership, transparency and governance – principles' (January 2014) and the timetable for meeting those principles, South West Water adopted its own Board leadership, transparency and governance Code (31 March 2014) which sets out how South West Water complies with the Ofwat principles.

The South West Water Code states that the Company will comply with the UK Corporate Governance Code to the extent that it can be applied to South West Water within the context of the Pennon Group structure. The Company will continue to regularly review its governance structures, ensuring it continues to carry out its business in a transparent way, designed to secure the Company's long-term success and profitability.

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 Company's future strategy.

In line with the new governance framework, performance evaluation processes for the Board will be embedded within the Pennon Plenary Board performance evaluation process going forward.

A performance evaluation was not undertaken for the year due to the impending introduction of the plenary structure. It is considered appropriate to undertake the next evaluation towards the end of 2016/17 to enable the assessment of performance of the new structure after it has been in operation during most of an annual cycle of business.

BOARD COMMITTEES' TERMS OF REFERENCE

In accordance with Company policies, a range of key matters are delegated to the Board's Committees.

The terms of reference of each of the Board's Committees are set out on the Pennon Group's website www.pennon-group.co.uk or are available on request to the Group Company Secretary.

BOARD SUPPORT AND TRAINING

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 and external advisors.

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' duty to avoid conflicts of interest under provisions of the Companies Act 2006 and the Company's Articles of Association which grant to Directors authority to approve such conflicts subject to appropriate condition.

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 2015/16 and up to the date of the approval of this Annual Report and Accounts.

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 2014/15 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.

SHAREHOLDER ENGAGEMENT

South West Water is a 100% owned subsidiary of Pennon Group Plc. South West Water's Non-executive Directors are invited to attend the Pennon Group strategy away day. The Chairman of the Board is also the Chairman of Pennon Group and the Pennon Group Chief Executive is a member of the Pennon Group Board. Both the Chairman and Pennon Group Chief Executive participate in Pennon's programme of regular dialogue with Pennon's institutional shareholders, which are described in the Pennon Group Annual Report and Accounts.

COMPLIANCE WITH THE UK CORPORATE GOVERNANCE CODE

Throughout the year, South West Water has complied with its own Board leadership, transparency and governance Code. The South West Water Code states that the Company will comply with the current UK Corporate Governance Code to the extent it can be applied to the Company in the context of the Pennon Group structure.

The UK Corporate Governance Code 2014 (the Code) is an updated version of the UK Corporate Governance Code issued by the Financial Reporting Council applicable to South West Water for the first time in 2014/15.

The Company has complied fully with the principals and spirit of the Code during the year, subject to the exceptions as described below. Most of the exceptions relate to the Group structure, where certain responsibilities rest with Pennon Group Plc (South West Water's parent company) which is fully compliant with the Code.

Provision A.4.1 of the Code states that the Board should appoint one independent Non-executive Director to be the Senior Independent Director. However, a Senior Independent Director has not been appointed due to the structure of the Group, as the South West Water Chairman is also the Chairman of the Pennon Group Plc (sole South West Water shareholder). Any shareholder concerns can therefore be communicated to the South West Water Board via the Group Chairman.

Provision B.3.1 – the appointment of the Chairman is the responsibility of the Pennon Group Nomination Committee.

Provisions B.6.1, B.6.2 – as previously noted (under Group Structure Review) a new Governance framework was introduced (as from April 2016) for Pennon Group and South West Water. As a result of these changes, the South West Water Board now meets as a separate Board within the Pennon Plenary Board, and for the reasons set out on page 40 a performance evaluation was not undertaken in the year.

As the South West Water Chairman is also the Chairman of Pennon Group Plc (South West Water's immediate and ultimate parent company), his performance evaluation is conducted separately by the Non-executive Directors of Pennon Group Plc, led by the Senior Independent Non-executive Director of Pennon Group Plc. Code provision B.6.3. states that the Nonexecutive Directors (of South West Water) should be responsible for the performance evaluation of the Chairman, however as noted above due to the Group structure the South West Water Chairman's performance evaluation is conducted by the Nonexecutive Directors of Pennon Group Plc.

Provisions C.3.2, C.3.7 of the Code state that the Audit Committee should make recommendations to the Board in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor. Provision C.3.2 states that the Audit Committee should develop and implement policy on the engagement of the external auditor to supply non-audit services. As the auditor is appointed on a Group basis, the appointment, re-appointment and removal of South West Water's external auditor is (and has been throughout the year) a matter for the Pennon Group Audit Committee.

Development and implementation of a policy on the engagement of the external auditor to supply non-audit services is also (and has also been throughout the year) a responsibility of the Pennon Group Audit Committee as it is more appropriate to consider on a Group wide basis. Prior to the establishment of the Plenary structure the Chairman of the South West Water Audit Committee regularly consulted with the Chairman of the Pennon Audit Committee in relation to external auditor matters.

Provision C.3.8. of the Code states that a separate section of the Annual Report should describe the work of the Committee in discharging its responsibilities, in particular an assessment of the effectiveness of the external audit process. Due to the Group structure, the overall assessment as to whether the external audit function is effective is (and has been throughout the year) the responsibility of the Pennon Group Audit Committee.

Provision D.2.2. of the Code states that the Remuneration Committee should have delegated responsibility for setting remuneration for all Executive Directors and the Chairman. However, the remuneration of the Chairman, who is also the Chairman of Pennon Group Plc and the Pennon Group Chief Executive Officer (previously the South West Water Chief Executive), who is also a member of the Pennon Group Plc Board is (and has been throughout the year) the responsibility of the Pennon Group Remuneration Committee.

During the year Pennon Group Plc complied fully with the UK Corporate Governance Code. Full reports of the Pennon Group Plc Board's Committees are contained within the Pennon Group Plc Annual Report and Accounts.

THE AUDIT COMMITTEE

INTRODUCTION

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.

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 Committee helps ensure good governance, overseeing the effectiveness and integrity of South West Water's financial reporting, internal control processes and risk management activities.

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. The Committee's 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.

SOUTH WEST WATER AUDIT COMMITTEE COMPOSITION AND MEETINGS

Five meetings of the South West Water Audit Committee were held during the year. Membership of the South West Water Audit Committee and their attendance was as follows:

Membership		Attendance
Martin Hagen	Chairman	5/5
Lord Matthew Taylor	Non-executive Director	5/5
Steve Johnson ⁽¹⁾	Non-executive Director	3/3
Duncan Ingram ⁽²⁾	Non-executive Director	3/3

⁽¹⁾ Stepped down from the Audit Committee in February 2016

⁽²⁾ Resigned 10 February 2016

In addition, the Chairman of the Board has had an open invitation to attend the Audit Committee meetings. Other regular attendees to the South West Water Audit Committee meetings include:

- Company Secretary
- Finance Director
- Regulatory Director
- Financial Controller
- Pennon Group Internal Audit Manager
- External Auditor.

Other Executive Directors and members of South West Water's Senior Management Team are invited to the Committee as appropriate.

In accordance with the UK Corporate Governance Code, the Board has determined that Martin Hagen, has recent and relevant financial experience. Martin Hagen is a current member (and former President) of the Institute of Chartered Accountants in England and Wales and previously senior partner of the professional services firm Deloitte's West of England practice.

All of the South West Water Audit Committee members were also members of the South West Water Remuneration Committee. This allowed them to provide input into both Committees on any performance matters and on the management of any risk factors relevant to remuneration matters.

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 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.

<p>Financial reporting</p>	<ul style="list-style-type: none"> • monitored the integrity of the financial statements of the Company and the half year and full year results including reviewing and discussing significant financial reporting judgements contained in the statements • reviewed and recommended to the Board the approval of the 2014/15 Annual Report and Financial Statements • considered and approved a process for confirming and recommending to the Board that the 2015/16 Annual Report and Financial Statements is fair, balanced and understandable in accordance with reporting requirements.
<p>Internal control and compliance</p>	<ul style="list-style-type: none"> • reviewed quarterly internal audit reports on audit reviews across the Company during the year • reviewed the internal control framework for the Company • considered the outcome of Quality Assurance reviews, ISO accreditations and other internal Company assurance work performed during the year • monitored performance on specific matters including the Company's MarketReady programme (preparing the Company for the opening of the Non-household retail market in April 2017).
<p>External auditor</p>	<ul style="list-style-type: none"> • considered the auditor's paper on its audit of the 2014/15 Annual Report and Financial Statements focusing on key findings • considered the auditor's report on their review of the 2015/16 half year results and key findings • reviewed and monitored audit/non-audit expenditure during 2014/15 • considered and approved the 2015/16 audit plan • considered the initial results of the 2015/16 external audit.

Risk management	<ul style="list-style-type: none"> • reviewed the risk management framework and compliance with that framework during 2015/16 and after the year-end until the publication of the Company's Annual Report and Financial Statements • reviewed the assessment of the risks by the Executive Directors • received as part of the risk management review the Annual Report on any whistleblowing.
Governance	<ul style="list-style-type: none"> • considered and approved new Annual Report disclosure requirements in line with revisions to the UK Corporate Governance Code to the extent which is possible in the context of being a Private Limited Company, subsidiary of the listed Pennon Group Plc • considered and approved accounting policies used in the preparation of the financial statements • held separate meetings with the external auditors and the internal group audit manager without members of management being present.

Since the year-end, the South West Water Audit Committee as part of the new Pennon Plenary framework reviewed the Company's 2015/16 results and the 2015/16 results of the Company's subsidiaries and considered the related key findings of the external auditor. In addition, it reviewed and recommended to the South West Water Board the approval of the 2015/16 Annual Report and Financial Statements, considering it fair, balanced and understandable as set out on page 51.

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.

This is the first year of the 2015-2020 regulatory period (K6). South West Water received 'enhanced plan' status when the Company's business plan was submitted for this five year period and are satisfied that the final determination from the Company's regulators Ofwat is financeable and that the business model, strategy and operations are sustainable.

South West Water are subject to an Regulatory Capital Value (RCV) based return which is linked to the Retail Price Index (RPI), with assets remaining 'ring fenced' in the wholesale business with a 25-year rolling licence. This clarity allows the Company to also align long-term debt to the RPI.

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.

A more detailed viability statement has also been made by the Board of Directors over a five year period (see pages 31 to 32).

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 auditor 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 on pages 108 to 109. The Committee paid particular attention to the following areas in the year ended 31 March 2016:

Provision for doubtful debt	
Throughout the year and particularly at each balance sheet date South West Water evaluates the collectability of trade receivables and records a provision for doubtful debts. This provision is based on segmenting South West Water customer base and including a provision percentage after considering the relative age of accounts, collections history, write-offs and future collectability.	<p>The Audit Committee has considered (previously at South West Water Board – full report in May) the appropriateness of the doubtful debt provisioning at the half and full year results.</p> <p>There have been no changes in the methodology for calculating this provision during 2015/16.</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>
Metered Accrual	
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.	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.0.4% of revenue, and is not considered to be significant by the Audit Committee.
Fixed asset depreciation charge	
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>The Audit Committee has considered the appropriateness of the accounting for capital expenditure and the asset lives assumed.</p> <p>During the year South West Water engaged an external consultant to review and benchmark South West Water's asset lives against other companies within the water industry.</p> <p>Through discussion with internal business experts and external research a small number of asset lives were adjusted.</p> <p>The reporting from external auditors has been 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.</p>

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 external auditor. Ernst & Young LLP (EY) was appointed as auditor in 2014 following a comprehensive competitive tender process led by the Pennon Group Audit Committee. 2015/16 is the second year of EY's appointment as South West Water's external auditor.

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

PROVISION FOR NON-AUDIT SERVICES

The Committee applies the Pennon Group policy for the engagement of the external auditor's firm for non-audit work. The Committee carefully reviews whether it is necessary for the auditor's firm to carry out such work and will only recommend 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 may be chosen in preference to the external auditors.

Set out in note 6 on page 110 is the level of fees paid to the Company's auditor's firm for audit services, audit related services and non-audit services.

The only non-audit work performed in both 2014/15 and 2015/16 by South West Water's external auditor is in respect of assurance on tariffs and charges for 2015/16 and the requirement for the Company Annual Report and regulatory reporting, which is not considered material work.

The Committee considered that the external auditor was best placed to provide certain review and recommend procedures as well as agreed upon procedures in connection with South West Water's annual submission of charges and tariffs for the forthcoming year because of their knowledge of South West Water's business and the inherent links with revenue reporting in the statutory financial results in 2016/17.

RISK AND ASSURANCE

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

INTEGRATED ASSURANCE FRAMEWORK

Throughout 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.

The framework utilises a risk based approach to ensure an appropriate balance of varied providers of assurance dependent on the assessed risk and complexity of assurance requirements.

This integrated assurance approach has been recognised as best practise as South West Water was one of only two companies to be assessed within the 'self assurance' category by Ofwat, which will be reviewed annually after Company regulatory reporting is published.

(i) Group independent 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.

A key input into the agreeing the audit plan is the review of the effectiveness of the Internal Audit function by the Audit Committee.

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 reactive maintenance, leakage, non-household retail services, credit management and debt collection.

The Group Internal Audit Manager 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.

(ii) Annual assurance (financial and technical audit)

Alongside the statutory external auditor, 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.

(iii) Quality assurance and ISO 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 certifications.

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

- ISO 9001: 2008 (quality management)
- ISO 14001: 2004 (environmental management)
- ISO 27001: 2005 (information security)
- ISO 17025: 2005 (laboratories and sampling)
- ISO 50001: 2011 (energy management)

These specific areas are also subject to periodic external reviews (such as ISO external reviews). South West Water was certified to ISO 50001: 2011 (energy management) for the first time during the year.

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.

In November Deloitte were appointed as South West Water's external assurance provider for its 'MarketReady' programme. This programme is preparing the Company for the non-household retail market opening in April 2017.

Market participants, including South West Water as a wholesaler and Pennon Water Services as a retailer, are required to submit three letters of assurance to the Company's regulator Ofwat and Market Operator Services Limited (MOSL).

Following external and internal assurance work completed the Board, Audit Committee and Management submitted assurance letters to Ofwat and MOSL in February stating that comprehensive programme plans have been established which provide a high level of confidence that the wholesale and retail businesses will be ready for market opening.

Further external and internal assurance work will be completed in 2016/17 ahead of the submission of assurance letters in respect of interim preparation for market opening and readiness for market opening.

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 high-level risks identified are presented together with how they are to be managed, in addition to details of any changes to existing risks and their management.

All Executive Directors and senior managers are required to certify on an annual basis that they have effective controls in place to manage risks and to operate in compliance with legislation and procedures.

South West Water also 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.

The results of the risk and control assessment will also inform the assurance approach taken (e.g. to perform additional internal reviews in areas of higher risk).

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 25 to 32.

For the 2015-2020 regulatory period, South West Water are now subject to separate regulatory revenue controls for various types of income streams. Previously there had been a single revenue control for the regulated business of South West Water. The risk management process has been aligned with the new revenue controls.

OFWAT COMPANY MONITORING FRAMEWORK

In February 2015, Ofwat published guidance on the monitoring and assurance requirements for water and sewage companies during the 2015-2020 regulatory period. It includes a framework, which adopts a risk based approach with respect to monitoring and assurance requirements for the water companies.

South West Water are one of only two water companies to have been categorised within the lowest risk 'self assurance' category, which means that it has no additional prescriptive assurance requirements in respect of regulatory performance reporting (including 'Outcome Delivery Incentives') beyond minimum requirements for all companies and can determine itself additional assurance provision.

South West Water will continue to apply the integrated assurance framework across the business to ensure a robust and rigorous approach to assurance.

FAIR, BALANCED AND UNDERSTANDABLE ASSESSMENT

To enable the Committee to advise the Board in making its statement that it considered the Company's Annual Report and Financial Statements is fair, balanced and understandable (FBU), the Committee has applied a detailed FBU review framework which takes account of the Company's well-documented verification process undertaken in conjunction with the preparation of the Annual Report and Financial Statements. This is in addition to the process carried out by the external auditor to enable the preparation of the independent auditor's report, which is set out on pages 88 to 95, and in addition to the work undertaken by the technical auditor.

In preparing and finalising the 2015/16 Annual Report and Financial Statements the Committee considered a report on the actions taken by management in accordance with the FBU process and an FBU assessment undertaken by the Executive Management Board. This assisted the Committee in carrying out its own assessment and being able to advise the Board that it considered that the Annual Report and Financial Statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy.

THE SUSTAINABILITY COMMITTEE

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.

Sustainability remains an integral part of South West Water's strategy and South West Water continues to take its responsibility very seriously in all its business and operational practices. Our investment and our commitment to high levels of service and performance will contribute to meeting our communities' long-term needs.

The Committee has established an annual programme to review activities and progress regarding issues of sustainability and corporate responsibility. Our aim is to ensure that the Company's decision-making and target-setting reflect best practice, not only in comparison with water industry peers but against a range of best practice businesses and sectors.

SUSTAINABILITY COMMITTEE COMPOSITION AND MEETINGS

Three meetings of the South West Water Sustainability Committee were held during the year. Members of the Committee and their attendance were as follows:

Membership		Attendance
Lord Matthew Taylor	Chairman	4/4
Martin Hagen ⁽¹⁾	Non-executive Director	3/3
Duncan Ingram ⁽²⁾	Non-executive Director	3/3
Steve Johnson ⁽³⁾	Non-executive Director	4/4
Chris Loughlin	Pennon Group Chief Executive	3/4
Monica Read ⁽⁴⁾	Business Services and Sustainability Director	3/3

⁽¹⁾ Stepped down from the Sustainability Committee in February 2016

⁽²⁾ Resigned 10 February 2016

⁽³⁾ Resigned 28 April 2016

⁽⁴⁾ Resigned 17 February 2016

THE COMMITTEE'S ACTIVITIES DURING THE YEAR

Matters considered during the year included:

- performance against sustainability targets for 2015/16.
- target setting for 2016/17.
- strategies and progress in relation to community engagement, employee engagement survey results, customers and the supply chain.
- Company policies.
- reporting and verification.

PERFORMANCE AGAINST SOUTH WEST WATER'S SUSTAINABILITY TARGETS

The Committee has reviewed South West Water's performance against its 12 sustainability targets for 2015/16 and the setting of further targets for the year ahead. South West Water met eight of the 12 sustainability targets during 2015/16. The Company aims to meet all 12 of these targets by the end of the 2015-20 regulatory period.

BUSINESS IN THE COMMUNITY

Sustainability is one of South West Water's guiding principles. In order to further strengthen the company's focus on maintaining and developing as a responsible business, the Committee recommended South West Water's membership of Business in the Community (BITC). In the 2016 Corporate Responsibility (CR) Index survey, which allows companies to benchmark their performance against industry peers, South West Water achieved a score of 84% or 2.5 stars. This is a very high score for a new entrant to the CR Index Survey. This assessment has provided a useful platform from which to make further improvements in how the company monitors and communicates its business activities from a sustainability perspective.

SUSTAINABILITY TARGETS

A summary of South West Water's performance against sustainability targets for 2015/16 is outlined in the following report. South West Water is making good progress against its targets and it aims to meet all targets by the end of the regulatory reporting period (2015-2020).

ENVIRONMENTAL SUSTAINABILITY

The protection of the environment is an essential aspect of ensuring that 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.

Target	Status
To ensure the average time taken to fix significant customer reported leaks is less than three days	MET
To achieve zero Category 1 and 2 pollution incidents which are our responsibility from waste water assets	NOT MET
To increase the number of farms that have an agreed plan to benefit the environment and the acres of farmland under revised management plans and delivering environmental outcomes in line with our Business Plans (2,202 Hectares and 840 Farms)	MET

COMMUNITY 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 our local communities and the quality of life that they enjoy.

Target	Status
To minimise our supply interruptions to customers and ensure that they do not exceed 0.256 hours per property	NOT MET
To increase the number of customers assisted through our water affordability initiatives in line with our Business Plans (to over 23,210)	MET
To invest at least £60k in the local community through sponsorship and charitable donations during the year and measure benefits this investment has delivered	MET

WORKPLACE SUSTAINABILITY

Engaged staff are critical to the success of the Company. Colleagues who are more engaged feel safer, are involved in fewer accidents at work, take fewer days off sick and receive more positive feedback from customers. Put simply, working to improve engagement is a key part of working to improve overall performance and sustainability.

Target	Status
To achieve an improving level of employee satisfaction / engagement in our annual survey (74%)	MET
Our desire is to have no accidents at work but our target is to achieve less than six RIDDORs during 2015	NOT MET
To have extended the recruitment of apprentices on our programme by the end of 2015/16 to a total of 52	MET

MARKETPLACE / CUSTOMER SUSTAINABILITY

Our ultimate goal is to provide our 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 turn, this helps South West Water to build a solid reputation for high quality customer service, which contributes to the creation of shareholder value.

Target	Status
To achieve an average of 86.8% of our customers being satisfied or very satisfied with our overall services	MET
To achieve an average of 55.6% of our customers being satisfied with the value for money of our services	MET
To ensure our water and wastewater activities are emitting a reduced level of greenhouse gas compared to 2014/15 in line with our business plan (water: 49.8ktCO ₂ e, wastewater: 103.96ktCO ₂ e)	NOT MET

VERIFICATION

South West Water's sustainability performance and reporting has been audited by South West Water's technical auditors, SMC, an independent management consultancy specialising in regulatory reporting.

THE NOMINATION COMMITTEE

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.

The Committee approved the appointment of Stephen Bird to the position of Managing Director of South West Water.

Last year the Committee led the recruitment process for the Finance Director and two new Non-executive Directors. The Nomination Committee of Pennon Group Plc led the process of appointing Sir John Parker, the new Chairman of both Pennon Group Plc and South West Water.

Sir John Parker, who took up his role of Chairman on 1 August 2015 also replaced Ken Harvey the former Chairman in his role as Chairman of the Nomination Committee.

NOMINATION COMMITTEE COMPOSITION

Membership of the South West Water Nomination Committee upto the end of January 2016 was as follows:

Membership	
Ken Harvey ⁽¹⁾	Chairman
Sir John Parker ⁽¹⁾	Chairman
Martin Hagen	Non-executive Director
Lord Matthew Taylor	Non-executive Director
Steve Johnson	Non-executive Director
Duncan Ingram ⁽²⁾	Non-executive Director

⁽¹⁾ Ken Harvey resigned on 31 July 2015 and was succeeded as Chairman on 1 August 2015 by Sir John Parker

⁽²⁾ Resigned 10 February 2016

DIVERSITY

The Company has a number of policies embracing workplace matters, including non-discrimination and equal opportunities policies. South West Water is seeking to grow through the diversity of talents and abilities in the Company. South West Water strives to eliminate bias and discrimination in the treatment of people, be they job applicants, employees, or members of the public, including bias and discrimination on grounds of gender.

South West Water as part of the Pennon Group Plc applies the group's diversity policy. This policy is considered in the appointment process of all Board members. Nonetheless all Board appointments are made on the basis of selecting the best candidate for the Board role being appointed and ensuring the successful candidate is able to make an influential contribution towards the future of the Company.

As at 31 March 2016 and as disclosed with the Directors' biographies on page 34 to 36, one of South West Water's Executive Directors is female and South West Water had 14% female representation at Board level. Following Non-executive Director appointments made on 1 April 2016, the female representation at Board level has increased to 20%. While circumstances on occasion will result in changes in Board composition, such as those which have arisen during the year, the Board is committed to moving towards a minimum of 25% female representation.

Female membership %	
The Board	14
Senior Management	23
Company	21

Female representation at Senior Management level has increased from 21% to 23% and female representation in the Company as a whole has remained at 21%. Whilst female representation on the Board reduced from 21% to 14% as at 31 March 2016, following Non-executive Director appointments made on 1 April 2016, 20% of the Board are now female.

THE REMUNERATION COMMITTEE

The Remuneration Committee's principal function is to consider the remuneration matters of the Company.

The Remuneration Committee meets in accordance with an annual calendar to consider remuneration matters in respect of the Company and in particular is responsible for:

- ensuring remuneration is aligned with and supports the Company's strategy; reflects the values as a Company and optimises performance
- maintaining and reviewing the remuneration policy to ensure it remains appropriate to attract and retain high calibre people who are able to continue the success of the Company
- advising the Board on the framework of executive remuneration for the Company
- determining the remuneration and terms of engagement of the Executive Directors and senior management of the Company.

Remuneration of employees other than Executive Directors is considered by Executive Directors and Senior Management. Trade Unions recognised by the Company are consulted as part of annual pay review processes. All employees of South West Water are members of a bonus scheme which takes into account Company performance (both financial and non-financial) as well as personal performance.

REMUNERATION COMMITTEE COMPOSITION AND MEETINGS

There were three meetings of the South West Water Remuneration Committee meetings in the year. Members of the Committee and their attendance were as follows:

Membership		Attendance
Martin Hagen	Chairman of the Committee	5/5
Ken Harvey	Chairman ⁽¹⁾ of the Board	3/3
Sir John Parker	Chairman ⁽¹⁾ of the Board	2/2
Lord Matthew Taylor	Non-executive Director	5/5
Steve Johnson	Non-executive Director	5/5
Duncan Ingram	Non-executive Director	5/5

⁽¹⁾ Ken Harvey resigned on 31 July 2015 and was succeeded as Chairman on 1 August 2016 by Sir John Parker

THE COMMITTEE'S ACTIVITIES DURING THE YEAR

During the year the Committee dealt with the annual executive salary review and determining performance targets in respect of the annual incentive bonus plan for 2015/16 and 2016/17.

THE DIRECTORS' REMUNERATION REPORT

The Directors' remuneration report for 2015/16 is set out separately on pages 59 to 80.

DIRECTORS' REMUNERATION REPORT

INTRODUCTION

Our current remuneration policy was approved in 2014 and last year we set out a summary of the policy information. We are providing a summary again for this year on pages 62 to 66 as we are once again not proposing any changes to the policy.

On pages 67 to 80 we set out our annual report on remuneration which contains the remuneration of the Directors for the year 2015/16 including the 'single remuneration figure' table providing a value for each element of remuneration for each Director, together with the details of the link between Company performance and remuneration during the year (pages 71 to 72). It also provides details of how our policy will be applied for 2016/17.

REMUNERATION DECISIONS FOR THE YEAR

For 2016/17 the salary of the Managing Director and Group Chief Executive (who remains a Director of South West Water) were not increased due to them being appointed to these positions towards the end of the year. The Finance Director's salary was increased by 21.7% due to the continuing glide path from a lower salary on appointment and having gained further experience together with performance in the role over the last year. This is in line with our approved policy on salaries on recruitment where 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.

The bonus outturns for the Executive Directors for 2015/16 reflect the achievements of the Company in the year, the Company's performance against corporate financial targets and the Executive Directors' performance against individual targets. Half of the bonus is deferred into shares. Further details of targets, measures and performance are set out on pages 71 to 72.

As regards the Company's long-term incentive plan, the overall estimated outturn for awards vesting at the end of the three year period ending 31 March 2016 is 34.5% of the maximum 100%. This reflects that the Pennon Group's total shareholder return is estimated to be 0.52% above the comparator index performance and is expected to rank 52% within the FTSE 250 group.

BOARD CHANGES

Sir John Parker became the Chairman on 1 August 2015 and his fee in the role was set at the same level as that of his predecessor. His fee for 2016/17 will be £266,350.

On 1 January 2016 Chris Loughlin became the Pennon Group Chief Executive Officer and Stephen Bird was appointed as Managing Director of South West Water. As these were new positions their salaries were set reflecting the fact that they were experienced Directors, having been promoted from Chief Executive of South West Water and Chief Operating Officer of South West Water respectively. Accordingly, pre-existing awards and contractual commitments will continue in accordance with their established terms. This is in accordance with the approved remuneration policy. No cash sign-on payments were made.

Following changes to the Board governance structure Monica Read resigned as registered Director of South West Water, but retains her responsibilities as Business Services and Sustainability Director. Duncan Ingram also resigned as Non-executive Director.

On 1 April 2016 existing Pennon Non-executive Directors Martin Angle, Neil Cooper and Gill Rider were appointed to the South West Water Board, aligning with the governance structure approved with Ofwat.

In addition, Steve Johnson also resigned on 28 April 2016 following his appointment to a new executive position.

LOOKING FORWARD

We will continue to review performance measures annually to ensure they are aligned with our strategy. For the financial year 2016/17 they have been adjusted as set out on page 68 to reflect the drive for synergies across the business and as South West Water prepares for industry change.

Our overall remuneration policy will be reviewed alongside the Pennon Group with the external independent remuneration consultants.

DIRECTORS' REMUNERATION POLICY

INTRODUCTION

The current Directors' remuneration policy set out in this report was approved in 2014.

The Remuneration Committee's intention is that approval of the remuneration policy will be sought at the end of the normal three year cycle in line with the remuneration reporting requirements.

The remuneration policy tables for Executive and Non-executive Directors are set out below. They have been reproduced, as approved in 2014, with the exception of updating to reflect Director changes; additional wording on malus, clawback and the holding period introduced in 2015 in the Pennon Group's Performance and Co-investment Plan; and minor and inconsequential changes.

The Directors' remuneration policy is displayed on the Pennon Group's website www.pennon-group.co.uk/about-us/directors-remuneration-policy and is available upon request from the Pennon Group Company Secretary.

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 appropriate candidates to meet the 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 in the Company and the Pennon Group • market rates • performance of individual and the Company • other factors it considers relevant. <p>There is no overall maximum.</p>	None, although individual and Company performance are factors considered when reviewing salaries.
Benefits			
Benefits are provided that 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 the individual's circumstances. There is no overall maximum benefit value but the Committee aims to ensure that the total value of benefits remain proportionate.	None.

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
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 three months after the end of the financial year.</p> <p>A portion of any bonus is deferred into shares in Pennon Group Plc, which are normally released after three years. Normally 50% is deferred.</p> <p>Any dividends on the shares during this period are paid to the Directors.</p> <p>The deferred bonus plan is operated in conjunction with Pennon Group's HMRC approved executive 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 from the 2014/15 financial year malus and clawback provisions apply. These provisions permit net cash bonuses and/or deferred bonus 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>Chris Loughlin – 100% of base salary of which 50% is cash and 50% is deferred.</p> <p>Stephen Bird, Louise Rowe – 75% of base salary of which 37.5% is cash and 37.5% is deferred.</p>	<p>Performance targets relate to corporate and personal objectives which are reviewed each year. Normally at least 60-70% relates to financial targets or 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>

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
Long term incentive plan (Performance and co-investment plan)			
<p>Provide alignment to shareholders and to longer- term Pennon Group's performance</p>	<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 of the 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><i>Introduced for 2015/16 onwards</i> For grants made from 2015 onwards malus and clawback provisions will apply which permit shares to be forfeited, repaid or made subject to further conditions where the Committee considers it appropriate in certain circumstances. The circumstances in which malus may be applied include (but are not limited to) a material misstatement, serious reputational damage, or the participant's misconduct. The circumstances in which clawback may be applied are material misstatements or serious misconduct.</p>	<p>The maximum annual award is: Chris Loughlin – 100% of base salary. Stephen Bird, Louise Rowe – 80% of base salary.</p>	<p>The current performance conditions are based on Total Shareholder Returns (TSR) of the Pennon Group with 50% based on TSR against the peer group index (chosen because these companies are regarded as Pennon Group's key listed comparators) and 50% based on TSR against constituents of the FTSE 250 index (excluding investment trusts) (chosen because this is the FTSE index to which the Pennon Group belongs currently). 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 for future awards if this were considered to be aligned with the Pennon Group's interests and strategic objectives.</p>

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
	<p>In addition a further two year holding period will apply in respect of any shares which vest at the end of the three year performance period.</p> <p>Malus maybe applied during the three year performance period and clawback may be applied up until the end of the holding period.</p>		
Pension			
<p>Provides funding for retirement and aids retention of key skills to assist in meeting the Company's strategic objectives.</p>	<p>Defined benefit pension arrangements are closed to new entrants. Defined contribution pension arrangements have been 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 15% of salary.</p> <p>For Executive Directors who commenced employment prior to April 2013 the maximum annual pension contribution or cash allowance is 21% or 30% of salary.</p> <p>Legacy defined benefit pension arrangements will continue to be honoured.</p>	<p>None.</p>
All-employee share plans			
<p>To align interests of all employees with Pennon Group's share performance.</p>	<p>Executive Directors may participate in HMRC approved all-employee plans on the same basis as employees.</p>	<p>The maximum is as prescribed under the relevant HMRC legislation governing the plans.</p>	<p>None.</p>

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		
<p>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>	<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 and an additional fee for any specific Board responsibility such as membership or chairmanship of a Committee.</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>	<p>Total fees paid to Non-executive Directors will remain within the limits stated in the Articles of Association.</p>
Benefits		
<p>Benefits for the Chairman are provided which are consistent with the market and level of seniority.</p>	<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, is entitled to expenses on the same basis as for other Non-executive Directors and, when appropriate for the efficient carrying out of his duties is provided with a driver and vehicle.</p>	<p>None.</p>

DIRECTORS SERVICE CONTRACTS / LETTERS OF APPOINTMENT

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

ANNUAL REPORT ON REMUNERATION

INTRODUCTION

This section sets out how the Company has applied its remuneration policy in the year, and details how the policy will be implemented for the year 2016/17.

OPERATION OF THE REMUNERATION POLICY FOR 2016/17

A summary of the specific remuneration arrangements for Executive Directors in 2016/17 is described below:

<p>Base salary</p>	<p>2016/17 salaries are: Chris Loughlin: £510,000¹ Stephen Bird: £240,000 Louise Rowe: £140,000</p> <p>Chris Loughlin, having been appointed Pennon Group Chief Executive Officer on 1 January 2016, did not receive a salary increase for 2016/17. Stephen Bird, having been appointed Managing Director on 1 January 2016, did not receive a salary increase for 2016/17. Louise Rowe received a 21.7% increase to reflect her performance in the role after being promoted to the position of Finance Director on 1 February 2015. This is in line with the Committee's approved policy on salaries on recruitment where 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.</p>
<p>Pension and benefits</p>	<p>No changes. Salary supplement cash allowance of 21% for S. Bird and 15% for L. Rowe from which is deducted the employer's contribution to the Defined Benefit or Contribution pension schemes for the Directors. Chris Loughlin receives a pension benefit equivalent to 30% of salary.</p>
<p>Annual bonus</p>	<p>No change to maximum opportunity of: Chris Loughlin: 100%¹ of salary Stephen Bird and Louise Rowe: 75% of salary</p> <p>No change to operation of deferral. 50% of the bonus is delivered as deferred shares. No changes will be made to the overall performance measurement framework for the annual bonus for 2016/17. Minor amendments to the role-specific measures have been made to reflect goals for the year as set out below:</p> <p>Following a review of the performance measures, annual bonus will be based on the following for 2016/17: Chris Loughlin (in his role as Pennon Group Chief Executive Officer): 30%¹ Pennon Group EPS performance 30%¹ personal strategic objectives 40%¹ measures specific to the role including in South West Water net debt, operating profit, RoRE (Return on Regulated Equity), Totex (Total Expenditure), performance and service improvements and in Viridor operating profit, net debt and adjusted EBITDA (earnings before interest, tax, depreciation, amortisation and non-underlying items plus joint ventures EBTIDA and IFRIC interest receivable).</p> <p>Stephen Bird, and Louise Rowe: 75% of salary 25% South West Water financial performance 20% defined service improvements 30% personal strategic objectives</p> <p>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 apply as described in the summary of the remuneration policy report.</p>

⁽¹⁾ From 1 January 2016, 50% of Chris Loughlin's remuneration is chargeable to South West Water through Pennon Group Recharges.

OPERATION OF THE REMUNERATION POLICY FOR 2015/16 CONTINUED

Performance and Co-Investment Plan (PCP)	<p>No change to maximum performance opportunity of 100% of base salary for C. Loughlin and 80% for S. Bird and L. Rowe with awards being subject to co-investment of 20% of the award and performance measures:</p> <ul style="list-style-type: none"> • 50% Pennon Group Plc's TSR vs FTSE 250 (excluding investment trusts) • 50% Pennon Group Plc's TSR vs a peer group index. <p>'Underpin' relating to overall Pennon Group performance, including consideration of environmental, social and governance factors and safety performance, as well as financial performance.</p> <p>For awards from 2015/16 both malus and clawback apply and a holding period applies in respect of any shares which vest at the end of the three year performance period as described in the summary of the remuneration policy report.</p>
Shareholding guidelines	No change. 100% of salary to be built up in the first five years of joining.

FORWARD-LOOKING PERFORMANCE TARGETS

Details of the annual bonus framework that will apply for each Executive Director for 2016/17 are set out in the table below:

Chris Loughlin	Pennon Group EPS*	30%
	Average of South West Water directors' performance including: <ul style="list-style-type: none"> • Operating profit • Net debt • RoRE performance • Totex (Total Expenditure) outperformance • Service improvements performance 	20%
	Average of Viridor directors' performance including: <ul style="list-style-type: none"> • Operating profit • Net debt • Adjusted EBITDA 	20%
	Personal strategic and delivery objectives	30%
	TOTAL	100%
Stephen Bird Louise Rowe	South West Water performance: <ul style="list-style-type: none"> • Operating profit • RORE[^] • Net debt • Totex (Total Expenditure) outperformance • Environmental, Customer and Employee Service Improvements 	45%
	Personal strategic and delivery objectives	30%
	TOTAL	75%

* Pennon Group EPS is before deferred tax and non-underlying net items.

[^] RORE is Return on Regulated Equity.

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

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

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

The comparator Index will comprise:

• Shanks Group	• National Grid	• United Utilities	• Suez Environment
• Severn Trent	• Séché Environment	• Veolia Environment	

NON-EXECUTIVE DIRECTOR FEES

Non-executive Director fees for 2016/17 are set out below. For additional work to be undertaken in connection with the Plenary Board, Lord Taylor and Martin Hagen's Non-executive Director fee increased by £5,000 from 1 April 2016. The Chairman's increase approved by the Committee was 1.5%.

Role	Fees £
Chairman	266,350 ⁽¹⁾
Non-executive Director fee	50,000

¹ 50% of this remuneration is chargeable to South West Water through Group Recharges.

Martin Angle, Neil Cooper and Gill Rider's Non-executive fees are set by Pennon Group Plc and for 2016/17 are; Martin Angle - £61,500, Neil Cooper - £65,000 and Gill Rider - £65,500. 50% of these fees are charged to South West Water through group recharges.

SINGLE TOTAL FIGURE OF REMUNERATION TABLES (AUDITED INFORMATION)

	Base salary/fees (£000)		Benefits (including sharesave) (£000)		Annual bonus (cash bonus and deferred shares) (£000)		Performance and co-investment plan (£000)		Pension (£000)		Total remuneration (£000)	
	2015 /16	2014 /15	2015 /16	2014 /15	2015 /16	2014 /15	2015 /16	2014 /15	2015 /16	2014 /15	2015 /16	2014 /15
Executive Directors												
Chris Loughlin, Pennon Chief Executive Office	304	310	21	21	257	242	88	–	91	93	761	666
Stephen Bird, Managing Director	199	172	18	16	117	116	64	–	63	74	461	378
Monica Read¹, Business Services and Sustainability Director	115	112	19	22	71	76	35	–	56	69	296	279
Louise Rowe, Finance Director	115	19	9	1	71	14	–	–	16	3	211	37
Non-Executive Directors												
Sir John Parker Chairman	110	–	–	–	–	–	–	–	–	–	110	–
Ken Harvey*, Chairman	44	131	4	12	–	–	–	–	–	–	48	143
Martin Hagen	45	41	–	–	–	–	–	–	–	–	45	41
Duncan Ingram²	45	26	–	–	–	–	–	–	–	–	45	26
Steve Johnson	45	26	–	–	–	–	–	–	–	–	45	26
Lord Matthew Taylor	45	41	–	–	–	–	–	–	–	–	45	41

* Retired 31 July 2015

¹ Resigned 17 February 2016. Remuneration is pro-rated for part-time service.

² Resigned 10 February 2016.

NOTES TO THE SINGLE TOTAL FIGURE REMUNERATION TABLE

- On 1 January 2016 Chris Loughlin was appointed Pennon Group Chief Executive Office as well as remaining an Executive Director South West Water. The disclosures above reflect 80% of his full remuneration up to 1 January 2016 which is paid directly by South West Water and subsequently 50% is chargeable through Pennon Group recharges.
- Sir John Parker and Ken Harvey were the Chairmen of Pennon Group Plc and South West Water. The disclosures above reflect 50% of their full remuneration which is chargeable to South West Water through Group recharges.

ANNUAL BONUS OUTTURN FOR 2015/16

The performance targets set and the performance achieved in respect of the annual bonus for 2015/16 in respect of each Executive Director is set out below.

Chris Loughlin

Chris Loughlin became Pennon Group Chief Executive Officer from 1 January 2016 and therefore different objectives are applied in the last three months of the year as set out below.

Targets applicable for the period 1 April 2015 to 31 December 2015						
Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
Pennon Group EPS	22.5%	31.6p	35.1p	40.4p	39.5p	18.28%
South West Water performance	30%	The average of the bonus earned by the other Executive Directors of South West Water in respect of targets which relate to: <ul style="list-style-type: none"> operating profit – the operating profits targets were £198.8m (threshold), £209.3m (target) and £219.8m (maximum); actual outturn was £215m Net debt* the position the company achieves in the 'Service Incentive Mechanism' of water and wastewater companies established by Ofwat* the achievement of a range of service standards set for the company by Ofwat* 				26.00%
Personal strategic objectives	22.5%	Implementing South West Water's new strategies and projects including the achievement of the transition milestones and synergies related to Bournemouth Water acquisitions and the delivery of opex/capex efficiency targets.*				21.00%
Total outturn	75%					65.28%
Targets applicable for the period 1 January 2016 to 31 March 2016						
Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
Pennon Group EPS [^]	7.5%	31.6p	35.1p	40.4p	38.9p	6.10%
South West Water performance	5%	The average of the bonus earned by the other executive directors of South West Water in respect of targets which related to: <ul style="list-style-type: none"> operating profit – the operating profit targets were £198.8m (threshold), £209.3m (target) and £219.8m (maximum); actual outturn was £215m net debt* the position the company achieves in the 'Service Incentive Mechanism' of water and wastewater companies established by Ofwat* the achievement of a range of service standards set for the company by Ofwat.* 				4.33%
Average Viridor director's performance	5%	The average of the bonus earned by the other Executive Directors of Viridor including targets that relate to: <ul style="list-style-type: none"> operating profit – the operating profit targets were £38.2m (threshold), £42.4m (target) and £46.6m (minimum); actual outturn was £40.9m Net debt* Adjusted EBITDA* The average also took into account collective strategic objectives relating to profitable revenue growth; forecasting process improvements; comparative health and safety performance; and implementation of organisational design.*				1.27%
Personal objectives	7.5%	Development of new role as Pennon Group Chief Executive Officer, completing the integration of Bournemouth Water and pursuing synergies across the Pennon Group.*				7.00%
Total outturn	25%					18.70%

* Some objectives and the targets continue to be commercially confidential.

Stephen Bird, Monica Read, Louise Rowe

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
South West Water's performance	45%	The average of the bonus earned by the other executive directors of South West Water in respect of targets which related to: <ul style="list-style-type: none"> operating profit – the operating profit targets were £198.8m (threshold), £209.3m (target) and £219.8m (maximum); actual outturn was £215m net debt* the position the company achieves in the 'Service Incentive Mechanism' of water and wastewater companies established by Ofwat* the achievement of a range of service standards set for the company by Ofwat.* 				34.67%
Personal objectives	30%	Implementing South West Waters new strategies and projects including the achievement of the transition milestones and synergies related to Bournemouth Water acquisitions and the delivery of opex/capex efficiency targets.*				S. Bird 24% M. Read 27% L. Rowe 27%
Total outturn	75%	Stephen Bird Monica Read Louise Rowe				58.67% 61.67% 61.67%

* Actual targets considered commercially confidential

PERFORMANCE & CO-INVESTMENT PLAN OUTTURN FOR 2015/16

The PCP awards made on 2 July 2013, which are due to vest on 2 July 2016, are the awards included in the single figure table and currently it is estimated that the outturn will result in a 34.5% vesting as set out in the table below.

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

• National Grid Plc	• Sèche Environnement	• Severn Trent
• Shanks Group	• Suez Environnement	• United Utilities

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

The calculation of Pennon Group's TSR performance over the three year performance period (being 1 April 2013 to 1 April 2016) for the PCP awards was undertaken by Deloitte LLP for the Pennon Group Remuneration Committee.

	Threshold (30% of maximum vests)	Maximum (100% of maximum vests)	Achievement in the period to 1 April 2016*	Vesting outturn*
Comparator Index (50% of award)	Equal to index	15% above the index	1.05% above the index	18.3%
FTSE 250 (excluding investment trusts) (50% of award)	Above 50th percentile	At or above 75th percentile	52.0%	16.2%
TOTAL				34.5%

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

* As 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 2016 to 30 June 2016) the achievement and the outturn is an estimate at the date of calculation 20 May 2016.

Vesting of the award is also subject to the 'underpin' described on page 64 which the Committee has determined to the date of this report would be satisfied.

TOTAL PENSION ENTITLEMENTS (AUDITED INFORMATION)

Stephen Bird and Monica 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 on page 70.

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

	Defined benefit pension accrued at 31 March 2016 ⁽¹⁾ £000 p.a.	Normal retirement age	Description of additional benefits available to the Director on early retirement
Stephen Bird	98	60	None
Monica Read	67	60	None

¹ The accrued pension is based on service to the year-end and final pensionable salary at that date.

Louise Rowe is a member of Pennon Group's defined contribution arrangement and received an overall pension benefit from the Company equivalent to 15% of her salary. Stephen Bird and Monica Read are members of the Pennon Group's defined benefit arrangements and received an overall pension benefit from the Company equivalent to 21% of their salaries. Chris Loughlin is not a member of any of the Pennon Group's pension schemes and receives a sum in lieu of pension entitlement equivalent to 30% of salary.

No additional benefits will become receivable by a Director in the event that the Director retires early. Chris Loughlin's normal retirement date is 67 which will be reached on 20 August 2019. Stephen Bird's normal retirement age is 60 which will be reached on 14 May 2018. Louise Rowe's normal retirement age is 65 which will be reached on 15 January 2047.

DATES OF DIRECTORS' SERVICE CONTRACTS/LETTERS OF APPOINTMENT

Executive Directors	Date of service contract	Expiry date of service contract
Stephen Bird*	1 March 2000	At age 60 (14 May 2018)
Chris Loughlin*	1 August 2006	At age 67 (20 August 2019)
Monica Read	1 September 2002	17 February 2016
Louise Rowe*	1 February 2015	At age 65 (15 January 2047)

* Each of the Executive Directors' service contracts is subject to 12 months' notice from either side.

Non-executive Directors	Date of letter of appointment	Expiry date of appointment
Sir John Parker	19 March 2015	Ongoing – subject to six months notice
Ken Harvey	1 April 2005	31 July 2015 (retired on this date)
Martin Angle	1 April 2016	30 November 2017
Neil Cooper	1 April 2016	30 August 2017
Martin Hagen	1 September 2010	31 August 2016
Duncan Ingram	1 September 2014	Resigned 10 February 2016
Steve Johnson	1 September 2014	Resigned 28 April 2016
Gill Rider	1 April 2016	30 August 2018
Lord Matthew Taylor	1 March 2010	28 February 2019

Non-executive Directors' letters of appointment contain three months notice from either side and the Chairman's letter of appointment contains a six month notice period from either side.

DIRECTOR CHANGES – ADDITIONAL INFORMATION

Retirement of Mr K G Harvey

Mr Harvey (Chairman) retired from office on 31 July 2015 and did not receive any compensation for loss of office.

Sir John Parker

Sir John Parker was appointed as a Non-executive Director and as Deputy Chairman of the Board on 1 April 2015. His fee was determined to be 50% of that of the then Chairman's fee and was increased to the same level as that of his predecessor upon his taking up the appointment as Chairman on 1 August 2015. When appropriate for the efficient carrying out of his duties, he is provided with a driver and vehicle. He is entitled to expenses on the same basis as for other Non-executive Directors.

Other Board changes

In preparation for the changes in governance and Board structures a number of other changes to the Board has resulted. Monica Read, Business Services and Sustainability Director and Duncan Ingram, Non-executive Director, resigned from the Board during February.

From 1 April 2016 existing Pennon Group Non-executive Directors were appointed to the South West Water Board. In addition Steve Johnson resigned from the South West Water Board on 28 April as a result of his new executive appointment which was considered a conflict of interest with South West Water.

Outside appointments

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

ALL EMPLOYEE, PERFORMANCE AND OTHER CONTEXTUAL INFORMATION

Remuneration of the Chief Executive

	2011/12	2012/13	2013/14	2014/15	2015/16 ⁽¹⁾
Chief Executive single figure remuneration	834	786	781	666	667
Annual Bonus payout (% of maximum)	86.8%	63.6%	85.1%	78.2%	84.06%
LTIP (PCP) vesting (% of maximum)	79.3%	50.0%	30.2%	0.0%	34.5%

¹ For 2015/16 this reflects the remuneration of Chris Loughlin as paid by or chargeable to South West Water.

COMPARISON OF EXECUTIVE DIRECTOR REMUNERATION TO EMPLOYEE REMUNERATION

The table below shows the percentage change between 2014/15 and 2015/16 in base salary, benefits and annual bonus for the average of the Executive Directors and all employees.

The percentage increase in salary is based on the actual increase received by the Chief Executive and the annual pay award to employees for 2015/16. The benefits available to employees and the Chief Executive have not changed during the year. The average bonus is the total amount paid or payable to the average number of employees 1,278 (2013/14: 1,221) as detailed in note 10 to the financial statements.

	Percentage change in salary	Percentage change in benefits	Percentage change in annual bonus
Chief Executive remuneration ¹	3.4%	0%	+5.8%
All employees	1.8% ²	0%	-1.0%

¹ Reflects percentage pay award for 2015/16 prior to appointment as Pennon Group Chief Executive

² Annual pay award for 2015/16 and estimated staff bonus levels.

RELATIVE IMPORTANCE OF SPEND ON PAY

	2015/16 (£m)	2014/15 (£m)	Percentage change
Overall expenditure on pay ¹	47.3	46.6	+1.5%
Distributions to Parent Company	74.9	255.8	-70.7%
Net interest charges	55.3	57.5	-3.8%
Purchase of property, plant and equipment (cash flow)	119.1	142.6	-16.5%

¹ Excludes employer's social security costs and non-underlying items.

The above table illustrates the relative importance of spend on pay compared with distributions to shareholders and other Company outgoings. The distributions to Parent Company, interest charges and the purchase of property, plant and equipment (cash flow) have been included as these were the most significant outgoings for the Company in the last financial year.

SHARE AWARD AND SHAREHOLDING DISCLOSURES (AUDITED INFORMATION)

Share awards granted during 2015/16

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
Chris Loughlin	PCP	100% of salary	400	30% of maximum	31 March 2018
Stephen Bird		80 % of salary	148		
Monica Read			104		
Louise Rowe			92		
Chris Loughlin	Deferred bonus / ESOS	50% of bonus awarded	151	n/a	26 July 2018
Stephen Bird			58		
Monica Read			39		
Louise Rowe			12		

PCP awards were calculated using the Pennon Group share price at the date of grant (2 July 2015) which was £8.105 per share. Deferred bonus awards were calculated using the Pennon Group share price at the date of grant (27 July 2015) which was £7.91.

The deferred bonus plan is operated in conjunction with the Pennon Group's HMRC approved executive 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 three year deferral period.

Directors' shareholding and interest in shares

The Remuneration Committee believes that the interests of Executive Directors and senior management should be closely aligned with the interests of shareholders.

To support this, the Committee operates shareholding guidelines. The Executive Directors are expected to build up a shareholding in Pennon Group 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 at the rate of at least 20% per year by the end of each year.

This level of shareholding is then expected to be maintained by each Director and is revalued each year in accordance with the then prevailing share price and the Executive Director's salary.

The beneficial interests of the Executive Directors in the ordinary shares (40.7p each) of Pennon Group Plc as at 31 March 2016 (or date of cessation, if earlier) and 31 March 2015 together with their shareholding guideline obligation and interest are shown in the table below:

	Share interests (including connected parties) at 31 March 2016	Share interests (including connected parties) at 31 March 2015	Share-holding guideline (100% to be accrued over five years)	Share-holding guideline met?	Unvested awards			
					Performance shares (subject to performance conditions)	SAYE	Deferred Bonus shares	ESOS
Chris Loughlin	247,745	225,045	100%	Yes	155,627	4,984	55,654	4,329
Stephen Bird	20,370	20,650	100%	Yes	56,116	2,259	20,879	4,329
Monica Read	65,521	59,123	100%	Yes	37,111	883	13,534	4,329
Louise Rowe	4,420	2,116	40%	Yes	11,351	2,789	1,553	1,553

Since 31 March 2016 3,618 additional ordinary shares in Pennon Group have been acquired by Chris Loughlin as a result of participation in the Pennon Group's scrip dividend alternative and the Pennon Group's Share Incentive Plan, and 87 additional ordinary shares in Pennon Group have been acquired by Louise Rowe as a result of participation in the Pennon Group's scrip dividend alternative and the Pennon Group's Share Incentive Plan.

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 the Pennon Group, are shown in the table below:

Director	Shares held at 31 March 2016	Shares held at 31 March 2015
Sir John Parker	10,000	–
Ken Harvey (retired 31 July 2015)	26,209	26,209
Martin Angle	–	–
Martin Hagen	3,600	3,600
Duncan Ingram	–	–
Steve Johnson	–	–
Lord Matthew Taylor	–	–

Since 31 March 2016 there have been no other changes in the beneficial interests. There is no formal shareholding guideline for the Non-executive Directors; however they are encouraged to purchase shares in Pennon Group Plc.

DETAILS OF SHARE AWARDS

(a) Performance and 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 2015	Conditional awards made in year	Market price upon award in year	Vesting in year ⁽¹⁾	Value of shares upon vesting (before tax) £000	Conditional awards held at 31 March 2016	Date of end of period for qualifying conditions to be fulfilled
Chris Loughlin							
3/7/12	48,145	-	768.50p	-	-	-	2/7/15
2/7/13	57,810	-	653.00p	-	-	57,810	1/7/16
14/7/14	48,465	-	798.50p	-	-	48,465	13/7/17
1/7/15	-	49,352	810.50p	-	-	49,352	30/6/18
Stephen Bird							
3/7/12	17,072	-	768.50p	-	-	-	2/7/15
2/7/13	20,594	-	653.00p	-	-	20,594	1/7/16
14/7/14	17,262	-	798.50p	-	-	17,262	13/7/17
1/7/15	-	18,260	810.50p	-	-	18,260	30/6/18
Monica Read							
3/7/12	10,826	-	-	-	-	-	2/7/15
2/7/13	13,059	-	-	-	-	13,059	1/7/16
14/7/14	11,221	-	-	-	-	11,221	13/7/17
1/7/15	-	12,831	810.50p	-	-	12,831	30/6/18
Louise Rowe							
1/7/15	-	11,357	810.50p	-	-	11,357	30/6/18

¹ None of the July 2012 award shares vested on 2 July 2015 due to the performance criteria not being met.

Therefore all 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 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 2015	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 2016	Date of end of period for qualifying conditions to be fulfilled
Chris Loughlin							
27/7/12 ¹	20,650	-	754.50p	20,650	163	-	26/7/15
5/8/13 ²	16,978	-	693.00p	-	-	16,978	4/8/16
27/8/14	19,552	-	821.50p	-	-	19,552	26/8/17
27/7/15	-	19,124	791.00p	-	-	19,124	26/7/18
Stephen Bird							
27/7/12 ¹	6,949	-	754.50p	6,949	55	-	26/7/15
5/8/13 ²	7,052	-	693.00p	-	-	7,052	4/8/16
27/8/14	6,509	-	821.50p	-	-	6,509	26/8/17
27/7/15	-	7,318	791.00p	-	-	7,318	26/7/18
Monica Read							
27/7/12 ¹	4,491	-	754.50p	4,491	36	-	26/7/15
5/8/13 ²	4,472	-	693.00p	-	-	4,472	4/8/16
27/8/14	4,128	-	821.50p	-	-	4,128	26/8/17
27/7/15	-	4,934	791.00p	-	-	4,934	26/7/18
Louise Rowe							
27/7/15 ²	-	1,553	791.00p	-	-	1,553	26/7/18

¹ These shares vested on 18 August 2015 at 791.10p per share.

² In addition to the awards made on 5 August 2013 (and 27 July 2015 to L Rowe) the Directors also received options pursuant to the Pennon Group's executive share option scheme (ESOS), details of which are set out below. These awards were made in conjunction with the operation of the bonus plan, details of which are set out on page 63.

During the year the Directors received dividends on the above shares in accordance with the conditions of the bonus plan as follows: Chris Loughlin £22,356*; Stephen Bird £8,119; Monica Read £5,240*, Louise Rowe £389.

* Chris Loughlin and Monica Read received their dividend in the form of ordinary shares (40.7p each) in Pennon Group Plc as a result of participation in the Pennon 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 that were acquired since 31 March 2016 given on page 76.

(c) Executive Share Option Scheme (ESOS)

The following Directors had a contingent interest in the number of options shown in the ordinary shares (40.7p each) of the Pennon Group pursuant to the Pennon Group's ESOS. Further details relating to the operation of the scheme are set out on page 63

Director and date of Award	Options held at 1 April 2015	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 2016	Options held at 31 March 2016 [^]	Maturity date
C. Loughlin 5/8/13	4,329	-	-	693.00p	-	811.00p	4,329	5/8/16
S. Bird 5/8/13	4,329	-	-	693.00p	-	811.00p	4,329	5/8/16
M. Read 5/8/13	4,329	-	-	693.00p	-	811.00p	4,329	5/8/16
L. Rowe 27/7/15	-	1,553	-	791.00p	-	811.00p	1,553	27/7/18

[^] Or at date of resignation.

(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 2015	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 2016	Options held at 31 March 2016 [^]	Exercise period/ maturity date
C. Loughlin 3/7/13	2,788	-	-	538.00p	-	811.00p	2,788	1/9/18 – 28/2/19
24/6/15	-	2,196	-	683.00p	-	811.00p	2,196	1/9/18 – 28/2/19
S. Bird 29/6/12	612	-	612	588.00p	-	-	-	1/9/15 – 28/2/16
3/7/13	501	-	-	538.00p	-	811.00p	501	1/9/16 – 28/2/17
14/7/14	441	-	-	611.00p	-	811.00p	441	1/9/17 – 28/2/18
M. Read 28/6/10	1,433	-	1,433	431.00p	-	-	-	1/9/15 – 28/2/16
14/7/14	883	-	-	611.00p	-	811.00p	883	1/9/17 – 28/2/18
L. Rowe 14/7/14	1,472	-	-	611.00p	-	811.00p	1,472	1/9/17 – 28/2/18
24/6/15	-	1,317	-	683.00p	-	811.00p	1,317	1/9/18 – 28/2/19

[^] Or at date of resignation.

BOARD OF DIRECTORS AND COMPANY INFORMATION

CHAIRMAN	K G Harvey (resigned 31 July 2015) Sir John Parker (appointed 31 July 2015)
PENNON GROUP CHIEF EXECUTIVE	C Loughlin
MANAGING DIRECTOR	S C Bird
FINANCE DIRECTOR	L F Rowe
BUSINESS SERVICES AND SUSTAINABILITY DIRECTOR	M S Read (resigned 17 February 2016)
NON-EXECUTIVE DIRECTORS	Lord Taylor of Goss Moor M J Hagen D G Ingram (resigned 10 February 2016) S Johnson (resigned 28 April 2016) M Angle (appointed 1 April 2016) N Cooper (appointed 1 April 2016) G Rider (appointed 1 April 2016)
COMPANY SECRETARIES	H Barrett-Hague (appointed 25 March 2016) K D Woodier (resigned 25 March 2016) K Gale R C Zmuda
REGISTERED OFFICE	Peninsula House Rydon Lane Exeter Devon EX2 7HR
INDEPENDENT AUDITOR	Ernst & Young LLP Apex Plaza Forbury Road Reading RG1 1YE
COMPANY'S REGISTERED NUMBER	02366665
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. From 1 April 2016 the Company also provides water supply services to parts of Dorset, Hampshire and Wiltshire (formerly operated by Bournemouth Water Limited).

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 81
- risk management objectives and policies (page 25)
- likely future developments of the Company (outlook sections of the strategic report)
- inclusion and gender diversity (page 57 of the corporate governance report)
- greenhouse gas emissions (page 15)
- statement of Directors' responsibilities in respect of the annual report and the financial statements (page 86)
- financial instruments (page 106 of the financial statements).

FINANCIAL RESULTS AND DIVIDEND

A total dividend for the year of £74.9m was paid during the year (2014/15: £255.8m). The 'Finance and Economy' section of the strategic report on pages 19 to 23 analyses the Company's financial results in more detail and sets out other financial information.

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.

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 81. Further details relating to the Directors and their service agreements or contracts for services are set out on page 73 and details of the Directors' interests in shares of Pennon Group Plc are given on pages 76 to 80.

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.

EMPLOYMENT POLICIES AND EMPLOYEE INVOLVEMENT

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.

This commitment to diversity and equality is demonstrated in all its employment activities including recruitment, training, career development and promotion and ensuring there is no bias or discrimination in the treatment of people. In particular, applications for employment are welcomed from persons with disabilities, and special arrangements and adjustments as necessary are made to ensure that applicants are treated fairly when attending for interview or for pre-employment aptitude tests. Wherever possible the opportunity is taken to retrain people who become disabled during their employment in order to maintain their employment within the Group. The Board also has a diversity policy and encourages gender diversity in particular. Further details are set out on page 57.

Employees are consulted regularly about changes which may affect them either through their trade union-appointed representatives or by means of the elected staff council.

These forums, together with regular meetings with particular groups of employees, are used to ensure that employees are kept up-to-date with the business performance of their employer and the financial and economic factors affecting the performance of the South West Water and the Pennon Group. The Group also cascades information monthly to all employees to provide them with important and up to date information about key events and to obtain feedback from them. Further information about employment matters relating to South West Water are set out on pages 17 to 18.

South West Water encourages share ownership among its employees by operating an HM Revenue & Customs approved Sharesave Scheme and Share Incentive Plan.

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 key suppliers who account for the large majority of expenditure.

We operate 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.

MODERN SLAVERY AND HUMAN TRAFFICKING

South West Water is committed to minimising the risk of slavery and human trafficking occurring both within the Company and within its supply chain. Pennon Group is in the process of drafting an anti-slavery and human trafficking statement for the financial year 2016/17. This will be available at www.pennon-group.co.uk upon publication.

POLITICAL DONATIONS

No political donations were made or political expenditure incurred and no contributions were made to a non-EU political party (2014/15: nil).

INCIDENTS AND PROSECUTIONS

In 2015/16 the Company was the subject of four prosecution cases brought by the Environment Agency (2014/15: seven). These cases resulted in South West Water being convicted of six offences with a total fine of £587,000 (2014/15: 12 offences with a total fine of £395,500).

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 Annual General Meeting of South West Water Limited will be held at Peninsula House, Rydon Lane, Exeter on 1 July 2016 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 2016.

RESOLUTION 2

To re-appoint Ernst & Young LLP 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. 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

25 May 2016

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.

Finally, in accordance with reporting requirements, the Board confirms that the Annual Report and Financial Statements taken as a whole are fair, balanced and understandable and provide the information necessary to assess the Company's performance, business model, and strategy as set out on page 6 .

STATEMENT AS TO DISCLOSURE OF INFORMATION TO THE COMPANY'S AUDITOR

a) so far as the Director is aware, there is no relevant audit information of which the Company's auditor is unaware; and

b) he / she has taken all the steps that he / she ought to have taken as a Director in order to make himself / herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

By Order of the Board



R C ZMUDA

Secretary

Peninsula House

Rydon Lane

Exeter

Devon

EX2 7HR

27 May 2016

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF SOUTH WEST WATER LIMITED

OPINION ON FINANCIAL STATEMENTS

In our opinion:

- South West Water Limited's financial statements give a true and fair view of the state of the Company's affairs as at 31 March 2016 and of its profit for the year then ended;
- the financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

WHAT WE HAVE AUDITED

We have audited the financial statements of South West Water Limited for the year ended 31 March 2016 which comprise the Income Statement, Statement of Comprehensive Income, Balance Sheet, Statement of Changes in Equity, Cash Flow Statement and the related notes 1 to 35. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

OVERVIEW OF OUR AUDIT APPROACH

Risks of material misstatement	<ul style="list-style-type: none"> • Revenue recognition across the Company's operations • Valuation of the provision for doubtful debts • Valuation of property, plant and equipment
Audit scope	<ul style="list-style-type: none"> • We performed an audit of the complete financial information of the Company
Materiality	<ul style="list-style-type: none"> • Overall materiality of £8m which represents approximately 5% of profit before taxation before non-underlying items

OUR ASSESSMENT OF RISKS OF MATERIAL MISSTATEMENT

We identified the risks of material misstatement described below as those that had the greatest effect on the overall audit strategy; the allocation of resources in the audit; and direction of the efforts of the audit team. The identified risks are consistent with prior year. In addressing these risks, we have performed the procedures below which were designed in the context of the financial statements as a whole and, consequently, we do not express any opinion on these individual areas.

<i>Risk</i>	<i>Risk direction</i>	<i>Our response to the risk</i>	<i>What we concluded to the Audit Committee</i>
<p>Revenue recognition across the Company's operations</p> <p>The Company's material revenue streams relate to the provision of water and sewerage services. ISAs (UK & Ireland) presume there is a risk of fraud relating to revenue recognition. For the Company, given targets</p>		<p>Our procedures include:</p> <ul style="list-style-type: none"> ▶ We obtained an understanding of the process for the supply of measured services, meter reading and related billing in order to challenge the completeness of adjustments to reflect the accrual or deferral of revenue ▶ We tested key controls linked to system generated information 	<p>We concluded that the basis of calculation of the measured income accrual is appropriate. Management assumptions in respect of customer demand are within an acceptable range.</p> <p>Amounts identified as advance billing have been correctly recorded.</p>

<i>Risk</i>	<i>Risk direction</i>	<i>Our response to the risk</i>	<i>What we concluded to the Audit Committee</i>
<p>associated to financial performance and also pressures to meet market expectations, there is a risk that revenue might be overstated. This risk over revenue recognition specifically arises in the following judgemental areas, where there is opportunity to overstate revenue:</p> <ul style="list-style-type: none"> ▶ Income from measured water services requires an estimation of the amount of unbilled charges at the year end. This is calculated using a combination of system generated information, based on previous customer volume usage, together with management judgements as to the likely impact on usage of factors such as recent weather patterns. The accrued income balance at 31 March 2016 is £63.5m (2015: £61.m) ▶ For unmeasured revenue, the bills for each calendar year are raised in advance for the next financial year. Therefore there is a risk that revenues are recorded in the incorrect period, if the advance billing element is not properly excluded and carried forward in the balance sheet. <p>Critical accounting judgements and estimates made by management in applying the Company's revenue recognition policy are disclosed in note 4.</p> <p>Audit Committee commentary is on pages 44 to 51.</p>		<p>and around the estimation process for measured revenue</p> <ul style="list-style-type: none"> ▶ We compared the accrued income to bills raised post year end for a sample of customers, and compared management's history of estimating the accrued income balance to bills raised in the subsequent year ▶ We performed a walkthrough of the process for unmeasured revenue and the annual billing cycle ▶ We performed controls testing related to the calculation of system generated billing for unmeasured revenue ▶ We obtained details of the billing runs in February and March and verified whether there were any other billing runs for unmeasured revenue that should be excluded from 2015/16 total revenue ▶ We corroborated the key assumptions and estimates made by management in recognising revenue, by obtaining internal and external data on factors that influence demand from customers ▶ We tested whether contract terms and conditions are met and revenue recognised at the correct time in accordance with IFRS ▶ We performed detailed analytical procedures by comparing revenue balances for the year against expectation and obtaining support for significant variances ▶ We performed detailed testing of samples of transactions to underlying bills for both types of revenue ▶ In performing our journal testing, we paid increased attention to entries impacting revenue, particularly those raised close to the balance sheet date. 	

Valuation of the provision for doubtful debts

As shown in note 16, there is a provision of £88.7m (2015: £81.0m) at the year end against gross trade debtors of £171.5m (2015: £160.0m).

The provision is calculated using a combination of system generated information on historic debt recovery rates and management's judgement of the future likely recovery rates.

There is a risk that the assumptions used by management in calculating the bad debt provision may be inappropriate and the valuation of the provision against trade receivables may be misstated.

Critical accounting judgements and estimates made by management, in providing for doubtful debts, are disclosed in note 4.

Audit Committee commentary is on pages 44 to 51.



Our procedures include:

- ▶ We tested controls over the integrity of data and the report utilised to generate the ageing and categorisation of debt within South West Water's billing system
- ▶ We tested historic data on collection rates and evaluated how this data was used in the preparation of the bad debt provision
- ▶ We corroborated the assumptions used by management in determining the amounts provided against the different categories and age of debt, by comparing these assumptions to historic collection rates and by considering the impact of changes in the methods adopted operationally by management to collect debt, and in the external environment.
- ▶ We utilised collection information over the past three years, to determine a range of the likely ultimate collection of debts existing at the balance sheet date and compared this to the provision recorded by management.

We concluded that the doubtful debt provision is within an acceptable range and reflects recent history of collection of outstanding debts.

Valuation of property, plant and equipment

As shown in note 12, the carrying value of the Company's property, plant and equipment totals £2,659.9m (2015: £2,636.9m).

Given targets associated to financial performance and also pressures to meet market expectations, there is a risk that expenditure might be improperly recognised as capital, rather than operating and that the depreciation charge may be understated if inappropriate useful economic lives are used.

Critical accounting judgements and estimates made by management, in assessing the carrying value of property, plant and equipment, are disclosed in note 4.

Audit Committee commentary is on page 47.

▶ We tested the classification of expenditure between capital and operating, considering whether the expenditure recorded as property, plant and equipment meets the definitions set out in IAS 16 'Property, Plant and Equipment'.

▶ We tested the asset lives utilised based on latest third party benchmarking.

▶ We re-performed the calculation of depreciation.

▶ We read the disclosures in the Annual Report and Financial Statements in respect of the change in asset lives and evaluated the adequacy of these.

We concluded that fixed assets have been correctly accounted for in the financial statements.

THE SCOPE OF OUR AUDIT

TAILORING THE SCOPE

The company's operations are based solely in the South West of England and therefore all audit procedures are completed by one audit team at the company's headquarters.

CHANGES FROM THE PRIOR YEAR

There were no changes in scope from the prior year.

CHANGES FROM THE PRIOR YEAR

There were no changes in scope from the prior year.

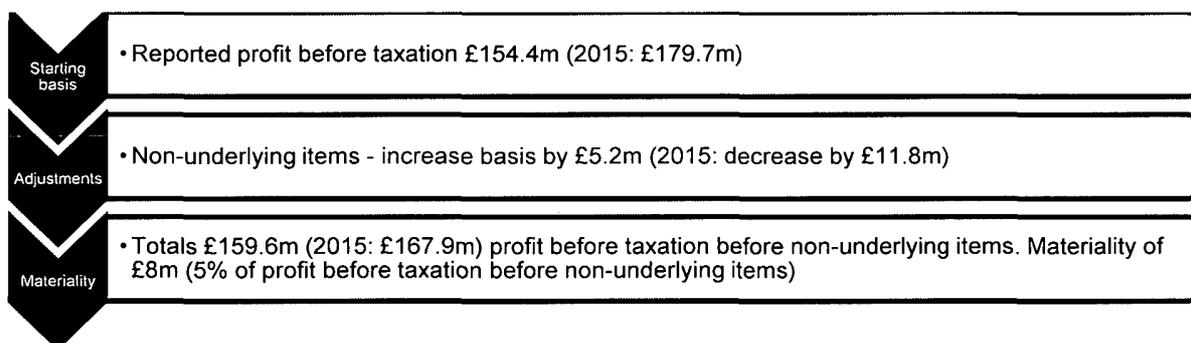
OUR APPLICATION OF MATERIALITY

We apply the concept of materiality in planning and performing the audit, in evaluating the effect of identified misstatements on the audit and in forming our audit opinion.

MATERIALITY

The magnitude of an omission or misstatement that, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the users of the financial statements. Materiality provides a basis for determining the nature and extent of our audit procedures.

We determined materiality for the Company to be £8m which is 5% of profit before taxation before non-underlying items. We believe that profit before taxation before non-underlying items provides us with an appropriate measure of the underlying performance of the Company. We excluded non-underlying items on the basis that these are infrequent in occurrence and profit before taxation after non-underlying items is not indicative of the underlying performance of the Company. We also note that market and analyst commentary on the performance of the Company uses the same measure. We therefore, considered profit before taxation before non-underlying items to be the most relevant performance metric on which to base our materiality calculation.



PERFORMANCE MATERIALITY

The application of materiality at the individual account or balance level. It is set at an amount to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

On the basis of our risk assessments, together with our assessment of the Company's overall control environment, our judgement was that performance materiality was 75% (2015: 50%) of our planning materiality, namely £6m. We have increased our assessment of performance materiality from 50% to 75% during the year, reflecting the fact that the prior year was a first year audit, and also based on our assessment of the Company's internal control environment and the extent and nature of audit findings identified in the prior period.

REPORTING THRESHOLD

An amount below which identified misstatements are considered as being clearly trivial.

We agreed with the Audit Committee that we would report to them all uncorrected audit differences in excess of £0.4 m, which is set at 5% of planning materiality, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in light of other relevant qualitative considerations in forming our opinion.

SCOPE OF THE AUDIT OF THE FINANCIAL STATEMENTS

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report and Financial Statements 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.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITOR

As explained more fully in the Directors' Responsibilities Statement set out on page 86, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and the terms of our engagement letter date 8 June 2015. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

The directors of South West Water Limited have voluntarily decided to comply with the UK corporate Governance code and have engaged us to provide an opinion on:

- ▶ the directors' statement in relation to going concern, set out on page 82, and longer-term viability, set out on pages 31 to 32; and
- ▶ the part of the Corporate Governance Statement relating to the company's compliance with the provisions of the UK Corporate Governance Code specified for our review

OPINION ON OTHER MATTERS PRESCRIBED BY THE COMPANIES ACT 2006

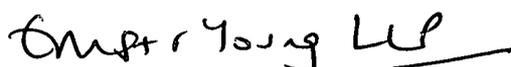
In our opinion the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

MATTERS ON WHICH WE ARE REQUIRED TO REPORT BY EXCEPTION

ISAs (UK and Ireland) reporting	<p>We are required to report to you if, in our opinion, financial and non-financial information in the annual report is:</p> <ul style="list-style-type: none"> • materially inconsistent with the information in the audited financial statements; or • apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Company acquired in the course of performing our audit; or • otherwise misleading. 	<p>We have no exceptions to report.</p>
Companies Act 2006 reporting	<p>We are required to report to you if, in our opinion:</p> <ul style="list-style-type: none"> • adequate accounting records have not been kept by the Company, or returns adequate for our audit have not been received from branches not visited by us; or • the company financial statements are not in agreement with the accounting records and returns; or • certain disclosures of directors' remuneration specified by law are not made; or • we have not received all the information and explanations we require for our audit. 	<p>We have no exceptions to report.</p>
The terms of our engagement letter	<p>Under the ISAs (UK and Ireland), for companies voluntarily applying the UK Corporate Governance Code, we are required to report to you if, in our opinion information in the annual report is:</p> <ul style="list-style-type: none"> • materially inconsistent with the information in the audited financial statements; or • apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Company acquired in the course of performing our audit; or • is otherwise misleading. <p>In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the annual report is fair, balanced and understandable and whether the annual report appropriately discloses those matters that we communicated to the audit committee which we consider should have been disclosed.</p> <p>Where the Company has voluntarily complied with items specified for review by the Listing Rules of the Financial Services Authority for premium listed UK incorporated companies and instructed us to review such items:</p> <ul style="list-style-type: none"> • the directors' statement in relation to going concern, set out on page 82, and longer-term viability, set out on page 31; and • the directors' statement, set out on page 82, in relation to going concern; and • the part of the Corporate Governance Statement relating to the Company's compliance with the provisions of the UK Corporate Governance Code specified for our review. 	<p>We have no exceptions to report.</p>

STATEMENT ON THE DIRECTORS' ASSESSMENT OF THE PRINCIPAL RISKS THAT WOULD THREATEN THE SOLVENCY OR LIQUIDITY OF THE ENTITY

<p>The terms of our engagement letter</p>	<p>Where the Company has voluntarily complied with items specified for review by the Listing Rules of the Financial Services Authority for premium listed UK incorporated companies and instructed us to review such items, wwe are required to give a statement as to whether we have anything material to add or to draw attention to in relation to:</p> <ul style="list-style-type: none"> • the directors' confirmation in the annual report that they have carried out a robust assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity; • the disclosures in the annual report that describe those risks and explain how they are being managed or mitigated; • the directors' statement in the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and their identification of any material uncertainties to the entity's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements; and • the directors' explanation in the annual report as to how they have assessed the prospects of the entity, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions. 	<p>We have nothing material to add or to draw attention to.</p>
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DEBBIE O'HANLON (Senior statutory auditor)
for and on behalf of Ernst & Young LLP, Statutory Auditor
Reading

Date 27 May 2016

Notes:

1. The maintenance and integrity of the South West Water Limited web site is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the web site.
2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

INCOME STATEMENT

FOR THE YEAR ENDED 31 MARCH 2016

	Notes	Before non- underlying items 2016 £m	Non- underlying items (note 5) 2016 £m	Total 2016 £m	Before non- underlying items 2015 £m	Non- underlying items (note 5) 2015 £m	Total 2015 £m
Revenue		506.4	-	506.4	523.6	-	523.6
Operating costs	6						
Employment costs		(40.3)	(4.7)	(45.0)	(39.8)	11.8	(28.0)
Raw materials and consumables used		(15.7)	-	(15.7)	(16.1)	-	(16.1)
Other operating expenses		(132.6)	(0.5)	(133.1)	(136.4)	-	(136.4)
Depreciation		(102.8)	-	(102.8)	(105.9)	-	(105.9)
Operating profit		215.0	(5.2)	209.8	225.4	11.8	237.2
Finance income	7	2.8	-	2.8	2.8	-	2.8
Finance costs	7	(58.2)	-	(58.2)	(60.3)	-	(60.3)
Net finance costs		(55.4)	-	(55.4)	(57.5)	-	(57.5)
Profit before tax		159.6	(5.2)	154.4	167.9	11.8	179.7
Taxation credit / (charge)	8	(22.2)	27.8	5.6	(35.4)	(2.4)	(37.8)
Profit for the year		137.4	22.6	160.0	132.5	9.4	141.9

STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 MARCH 2016

	Notes	Before non- underlying items 2016 £m	Non- underlying items (note 5) 2016 £m	Total 2016 £m	Before non- underlying items 2015 £m	Non- underlying items (note 5) 2015 £m	Total 2015 £m
Profit for the year		137.4	22.6	160.0	132.5	9.4	141.9
Other comprehensive income/(loss)							
Items which will not be reclassified to profit or loss							
Remeasurement of defined benefit obligations	22	(3.6)	-	(3.6)	1.7	-	1.7
Income tax on items that will not be reclassified	23	0.7	(2.1)	(1.4)	(0.4)	-	(0.4)
Total items that will not be reclassified to profit or loss		(2.9)	(2.1)	(5.0)	1.3	-	1.3
Items that may be reclassified subsequently to profit or loss							
Cash flow hedges:							
Net fair value losses		(7.1)	-	(7.1)	(23.5)	-	(23.5)
Income tax on items that may be reclassified	23	1.4	(0.8)	0.6	4.1	-	4.1
Total items that may be reclassified subsequently to profit or loss		(5.7)	(0.8)	(6.5)	(19.4)	-	(19.4)
Other comprehensive loss for the year net of tax		(8.6)	(2.9)	(11.5)	(18.1)	-	(18.1)
Total comprehensive income for the year		128.8	19.7	148.5	114.4	9.4	123.8

The notes on pages 100 to 130 form part of these financial statements.

BALANCE SHEET

AT 31 MARCH 2016

	Notes	2016 £m	2015 £m
Assets			
Non-current assets			
Property, plant and equipment	12	2,659.9	2,636.9
Derivative financial instruments	17	–	0.2
Investment in subsidiary undertakings	14	3.3	3.3
		2,663.2	2,640.4
Current assets			
Inventories	15	5.5	5.2
Trade and other receivables	16	117.4	119.2
Derivative financial instruments	17	–	0.1
Cash and cash deposits	18	251.2	246.9
		374.1	371.4
Liabilities			
Current liabilities			
Borrowings	20	(104.6)	(183.8)
Derivative financial instruments	17	(14.4)	(12.7)
Trade and other payables	19	(79.3)	(75.1)
Current tax liabilities		(10.8)	(27.5)
Provisions	24	(6.7)	(2.0)
		(215.8)	(301.1)
Net current assets		158.3	70.3
Non-current liabilities			
Borrowings	20	(1,939.9)	(1,880.6)
Other non-current liabilities	21	(80.5)	(74.3)
Derivative financial instruments	17	(29.3)	(25.8)
Retirement benefit obligations	22	(29.6)	(41.5)
Deferred tax liabilities	23	(211.8)	(232.2)
		(2,291.1)	(2,254.4)
Net assets		530.4	456.3
Equity			
Called up share capital	25	150.9	150.9
Retained earnings and other reserves	27	379.5	305.4
Total Equity		530.4	456.3

The notes on pages 100 to 130 form part of these financial statements.

The financial statements on pages 96 to 130 were approved and authorised for issue by the Board of Directors on 27 May 2016 and were signed on its behalf by:



S Bird
Managing Director

Registered office: Peninsula House, Rydon Lane, Exeter, Devon, England EX2 7HR
Registered Number: 02366665

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 MARCH 2016

	Called up share capital (note 25) £m	Retained earnings and other reserves (note 27) £m	Total Equity £m
At 31 March 2014	150.9	436.0	586.9
Profit for the year	–	141.9	141.9
Other comprehensive loss for the year	–	(18.1)	(18.1)
Total comprehensive income for the year	–	123.8	123.8
<i>Transactions with owners</i>			
Dividends paid	–	(255.8)	(255.8)
Share based payments	–	1.4	1.4
Total transactions with owners	–	(254.4)	(254.4)
At 31 March 2015	150.9	305.4	456.3
Profit for the year	–	160.0	160.0
Other comprehensive loss for the year	–	(11.5)	(11.5)
Total comprehensive income for the year	–	148.5	148.5
<i>Transactions with owners</i>			
Dividends paid	–	(74.9)	(74.9)
Share based payments (net of tax)	–	0.5	0.5
Total transactions with owners	–	(74.4)	(74.4)
At 31 March 2016	150.9	379.5	530.4

The notes on pages 100 to 130 form part of these financial statements.

CASH FLOW STATEMENT

FOR THE YEAR ENDED 31 MARCH 2016

	Notes	2016 £m	2015 £m
Cash flows from operating activities			
Cash generated from operations	28	298.5	315.5
Interest paid		(49.6)	(49.2)
Tax paid		(32.4)	(36.4)
Net cash generated from operating activities		216.5	229.9
Cash flows from investing activities			
Interest received		0.4	0.9
Receipt of grants and contributions		5.3	3.4
Purchase of property, plant and equipment		(119.1)	(142.6)
Proceeds from sale of property, plant and equipment		1.7	1.4
Net cash used in investing activities		(111.7)	(136.9)
Cash flows from financing activities			
Deposit of restricted funds		(16.8)	(29.1)
Proceeds from new borrowing		80.0	–
Repayment of borrowings		(31.1)	(31.1)
(Repayments) / proceeds from intercompany borrowings		(80.0)	130.0
Finance lease sale and lease back		31.0	85.6
Finance lease principal repayments		(27.7)	(92.3)
Dividends paid		(74.9)	(255.8)
Net cash used in financing activities		(119.5)	(192.7)
Net decrease in cash and cash equivalents		(14.7)	(99.7)
Cash and cash equivalents at beginning of the year		51.9	151.6
Cash and cash equivalents at end of the year	18	37.2	51.9

The notes on pages 100 to 130 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 81. The nature of the Company's operations and its principal activities are set out on page 81.

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 customers and certain financial instruments as described in accounting policy note (s) and (r) 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 the financial statements as stated by the Directors on page 82.

The New standards or interpretations which were mandatory for the first time in the year beginning 1 April 2015 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, except the following set out below:

- IFRS 15 'Revenue from contracts with customers' relates to revenue recognition and establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. The standard will replace IAS 18 'Revenue' and IAS 11 'Construction contracts' and related interpretations. The standard is effective for annual periods beginning on or after 1 January 2018 and is subject to EU endorsement.
- The Company continues to assess the impact of the new standard on the Company's financial statements. The Company will make more detailed assessments of the impact over the next twelve months.
- IFRS 16 'Leases' no longer distinguish between an on the balance sheet finance lease and an off the balance sheet operating lease. Instead, for virtually all lease contracts the lessee recognises a lease liability reflecting future lease payments and a 'right-of-use' asset. The standard is effective for annual periods beginning on or after 1 January 2019 and is subject to EU endorsement.
- The Directors anticipate that the adoption of IFRS 16 on 1 April 2019 will reduce operating costs, increase depreciation charges and increase finance costs. In addition, c.£25m of property, plant and equipment will be recognised, with a corresponding increase in borrowings and net debt. Existing borrowing covenants are not impacted by changes in accounting standards.

The accounting policy for non-underlying items (t), previously referred to as exceptional items, has been refined to include items which due to their nature in the view of the Director's should be separately disclosed to enable a full understanding of the Company's financial performance.

(b) Exemption from consolidation

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

(c) Revenue recognition

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

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

Revenue from main water and wastewater 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.

Revenue is recognised to the extent that it is probable that economic benefits will flow to the Company and revenue can be reliably measured.

2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

(d) Segmental reporting

The Directors believe that the whole of the Company's activities constitute one single segment. 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 the 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 – 120 years
Sewers	40 – 120 years

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

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 (s).

The assets' residual values and useful lives are reviewed annually. With effect from 1 April 2015, the useful lives for certain assets have been amended where both external benchmarking and internal experience indicates a change is required. Lives for some assets have increased whilst others have decreased. To accommodate this change the range of useful lives for water mains and sewers has increased from 100 to 120 years. This has resulted in a net reduction in the total depreciation charge for 2015/16 of £5.1m.

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

2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

(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.

(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) Inventories

Inventories are stated at the lower of cost and net realisable value. The cost of finished goods and work in progress includes raw materials and the cost of bringing stocks to their present location and condition. It excludes borrowing costs. Net realisable value is the estimated selling price less cost to sell.

(k) 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.

2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

(I) Derivatives and other financial instruments

The Company classifies its financial instruments in the following categories:

i) Loans and receivables

All loans and borrowings are initially recognised at 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 and exchange rate fluctuations. Derivative instruments are initially recognised at fair value on the date the derivative contract is entered into and subsequently remeasured at fair value for the reported balance sheet.

The company designates certain hedging derivatives as either:

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

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

In order to qualify for hedge accounting, the Company is required to document in advance the relationship between the item being hedged and the hedging instrument. The Company is also required to document and demonstrate an assessment of the relationship between the hedged item and the hedging instrument which shows that the hedge will be highly effective on an ongoing basis. This effectiveness testing is reperformed at the end of each reporting period to ensure that the hedge remains highly effective.

The full fair value of a hedging derivative is apportioned on a straight line basis between non-current and current assets or liabilities based on the remaining maturity of the hedging derivative.

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.

2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

(m) 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 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 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. Payments for group relief are included within the current tax disclosures.

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

(n) Provisions

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

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

(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 estimated.

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.

(q) Employee benefits

i) Retirement benefit obligations

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

Defined benefit pension schemes

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.

2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

(q) Employee benefits continued

i) Retirement benefit obligations continued

Defined benefit pension schemes continued

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 period in which they arise.

ii) Share-based payment

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

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

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

(r) Fair values

The fair value of the interest rate swaps is based on the market price of comparable instruments at the balance sheet date if they are publicly traded.

The fair values of short-term deposits, loans and overdrafts with a maturity of less than one year are assumed to approximate to their book values. In the case of non-current bank loans and other loans, the fair value of financial liabilities for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate available to the Company for similar financial instruments.

(s) Transfers of assets from customers

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

(t) Non-underlying items

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

3. FINANCIAL RISK MANAGEMENT

(a) Financial risk factors

The Company's activities expose it to a variety of financial risks; market risk (interest rate risk), liquidity risk and credit risk. The company receives treasury services from the treasury function of Pennon Group Plc, the parent company, which seeks to ensure that sufficient funding is available to meet foreseeable needs, maintains reasonable headroom for contingencies and manages 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.

3. FINANCIAL RISK MANAGEMENT CONTINUED

(a) Financial risk factors continued

i) Market risk

The Company has both interest bearing assets and interest bearing liabilities. The company has a policy of maintaining, after the effect of interest rate swaps, at least 50% of interest bearing liabilities at fixed rates. At the year end 74% (2015: 63%) of net borrowings were at fixed rates and 22% (2015: 22%) index-linked. The Company uses a combination of fixed rate and index-linked borrowings and fixed rate interest swaps as cash flow hedges of future variable interest payments to achieve this policy. The notional principal amounts of the interest rate swaps are used to determine settlement under those swaps and are not, therefore, an exposure for the company. These instruments are analysed in more detail in note 17.

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

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 28) are independent of changes in market interest rates.

For 2016 if interest rates on variable net borrowings had been on average 0.5% higher/ lower with all other variables held constant, post-tax profit for the year and equity would have decreased/ increased by £0.2m (2015 £0.2m), for the equity sensitivity fair value, derivative impacts are excluded.

For 2016 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 and equity would have decreased/ increased by £1.5m (2015 £1.5m).

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 20.

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

	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
31 March 2016					
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	88.7	41.1	102.0	566.2	798.0
Interest payments on borrowings	17.5	17.7	61.0	587.2	683.4
Finance lease liabilities including interest	31.4	35.6	155.7	2,076.1	2,298.8
Derivative financial liabilities					
Derivative contracts – net payments	12.2	10.0	15.2	0.5	37.9
31 March 2015					
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	31.1	38.7	234.5	1,239.0	1,543.3
Interest payments on borrowings	17.2	22.8	51.5	611.7	703.2
Finance lease liabilities including interest	34.5	35.9	172.3	2,105.3	2,348.0
Derivative financial liabilities					
Derivative contracts – net payments	10.6	9.3	15.9	–	35.8

3. FINANCIAL RISK MANAGEMENT CONTINUED

(a) Financial risk factors continued

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 16.

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 2016 the company had cash and committed facilities excluding restricted funds of almost £722m, meeting this objective.

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 29 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:

	2016 £m	2015 £m
Net Borrowings (note 29)	1,793.3	1,817.5
Total equity	530.4	456.3
Total capital	2,323.7	2,273.8
Gearing Ratio	77.2%	79.9%

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). South West Water's net debt to RCV has decreased to 60%, which compares to Ofwat's K6 target for efficient gearing of 62.5%.

	2016 £m	2015 £m
Regulatory Capital Value	2,997.3	2,928.0
Net borrowings (note 29)	1,793.3	1,817.5
Net borrowings / Regulatory Capital Value	60%	62%

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 17.

3. FINANCIAL RISK MANAGEMENT CONTINUED

(c) Determination of fair values continued

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.

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 2016 the Company's current amounts receivable from customers were £191.8m, against which £88.7m had been provided for impairment (note 16).

(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 2013.

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 22 of the financial statements.

(d) Taxation

The company's current tax provision of £10.8m relates to management's judgement of the amount of tax payable on open tax computations where liabilities remain to be agreed with HMRC. The company evaluates uncertain tax items, where a tax item is subject to interpretation and remains to be agreed. Provisions established for uncertain items are made using a best estimate of the tax expected to be paid, based on a qualitative assessment of all relevant information.

In assessing any appropriate provision requirements for uncertain tax items the company considers progress made in discussions with HMRC, expert advice on the likely outcome and any recent developments in case law.

Due to the uncertainty associated with such tax items, it is possible that at a future date, on conclusion of the open matters, the final outcome may vary significantly. Any such variations will affect the tax financial results in the year in which such a determination is made.

4. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES CONTINUED

(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 2016 was £2,659.9m. In the year ended 31 March 2016 additions to property, plant and equipment totalled £126.3m and the depreciation charge was £105.1m. 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.

5. NON-UNDERLYING ITEMS

Non-underlying 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.

	2016 £m	2015 £m
Restructuring costs	(5.2)	–
Pension costs – past service	–	11.8
Net operating costs	(5.2)	11.8
Tax arising on non-underlying item:		
Tax credit / (charge) arising on non-underlying items	1.0	(2.4)
Deferred tax – change in rate	26.8	–
Net non-underlying credit	22.6	9.4

During the year a one-off charge of £5.2m was made to the restructuring provision reflecting announced reorganisations across the Company. Last year a non-underlying credit was recognised relating to changes made to the Pennon Group's defined benefit pension scheme. Changes implemented last year capped pensionable pay for active members, reducing past service cost. Following the enactment during the year the rate of corporation tax reduced from 20% to 19% from April 2017 and reduces further to 18% from April 2020. As a result a 'one off' credit of £26.8m has been recognised in the income statement.

In addition, a charge of £2.9m has been recognised in the Statement of Comprehensive Income and a charge of £0.1m has been recognised, in equity directly.

6. OPERATING COSTS BEFORE NON-UNDERLYING ITEMS

	2016 £m	2015 £m
Employment costs (note 10)	40.3	39.8
Raw materials and consumables	15.7	16.1
<i>Other operating expenses include</i>		
Profit on disposal of property, plant and equipment	(1.4)	(1.2)
<i>Operating lease rentals payable:</i>		
Plant and machinery	1.4	1.2
Property	1.6	1.4
Research and development expenditure	0.1	0.1
Trade receivables impairment (note 16)	7.7	9.1
<i>Depreciation of property, plant and equipment:</i>		
Owned assets	69.5	72.6
Under finance leases	33.3	33.3
	102.8	105.9

6. OPERATING COSTS BEFORE NON-UNDERLYING ITEMS CONTINUED

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

	2016 £000	2015 £000
Fees payable to the Company's auditors and its associates for the audit of the financial statements	207	175
Fees payable to the Company's auditors and its associates for other services:		
All other services	19	7
Total fees	226	182

Expenses reimbursed to the auditors in relation to the audit of the Company were £16,000 (2015: £12,000).

A description of the work of the Audit Committee is set out in its report on page 44 to 57 which includes an explanation of how the auditor's objectivity and independence are safeguarded when non-audit services are provided by the auditor's firm.

7. NET FINANCE COSTS

	2016			2015		
	Finance cost £m	Finance income £m	Total £m	Finance cost £m	Finance income £m	Total £m
Cost of servicing debt						
Bank borrowings and overdrafts	(9.7)	–	(9.7)	(8.3)	–	(8.3)
Interest element of finance lease rentals	(31.4)	–	(31.4)	(31.6)	–	(31.6)
Other finance costs	(2.2)	–	(2.2)	(5.3)	–	(5.3)
Interest receivable	–	2.8	2.8	–	2.8	2.8
Intercompany interest to subsidiaries	(13.5)	–	(13.5)	(13.0)	–	(13.0)
Working capital adjustment	(56.8)	2.8	(54.0)	(58.2)	2.8	(55.4)
Notional interest						
Retirement benefit obligations (note 22)	(1.4)	–	(1.4)	(2.1)	–	(2.1)
Finance (costs)/income	(58.2)	2.8	(55.4)	(60.3)	2.8	(57.5)

In addition to the above, finance costs of £1.4m (2015: £2.4m) have been capitalised on qualifying assets included in property, plant and equipment.

8. TAXATION

	Before non- underlying items 2016 £m	Non- underlying items (note 5) 2016 £m	Total 2016 £m	Before non- underlying items 2015 £m	Non- underlying items (note 5) 2015 £m	Total 2015 £m
Analysis of charge in year						
<i>Current tax</i>						
Current year tax charge	27.2	(1.0)	26.2	33.0	-	33.0
Prior year tax charge	(10.5)	-	(10.5)	(3.2)	-	(3.2)
Total current tax charge	16.7	(1.0)	15.7	29.8	-	29.8
<i>Deferred tax</i>						
Current year tax charge	5.7	-	5.7	4.5	2.4	6.9
Prior year tax charge	(0.2)	-	(0.2)	1.1	-	1.1
Deferred tax arising on change of rate of corporation tax (note 23)	-	(26.8)	(26.8)	-	-	-
Total deferred tax charge / (credit)	5.5	(26.8)	(21.3)	5.6	2.4	8.0
Total (credit) / charge for the year	22.2	(27.8)	(5.6)	35.4	2.4	37.8

UK Corporation tax is calculated at 20% (2015: 21%) of the estimated assessable profit for the year.

The 2016 deferred tax credit includes a credit of £26.8m reflecting a reduction in the rate of corporation tax.

The tax for the year differs from the theoretical amount that would arise using the standard rate of corporation tax in the UK of 20% (2015: 21%). The differences are explained below:

	2016 £m	2015 £m
Profit before tax	154.4	179.7
Profit before tax multiplied by the standard rate of corporation tax in the UK of 20% (2015: 21%)	30.9	37.7
<i>Effects of:</i>		
Expenses not deductible for tax purposes	1.0	2.5
Adjustments to tax charge in respect of prior year	(10.7)	(2.1)
Change in rate of corporation tax	(26.8)	-
Other	-	(0.3)
Tax (credit) / charge for year	(5.6)	37.8

The adjustments to the tax charge in respect of prior years, include an updated assessment of uncertain tax items following discussions with HMRC on complex tax legislation relating to the deductibility of financial arrangements and relief claims for capital expenditure, plus submission of the prior year tax returns resulting in lower tax being due compared to the assessment made for the 2014/15 charge.

The average effective current tax rate including non-underlying items for the year was 10% (2015: 17%).

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

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

	2016 £m	2015 £m
Amounts recognised directly in other comprehensive income		
Deferred tax charge on defined benefit pension schemes	1.4	0.4
Deferred tax credit on cash flow hedges	(0.6)	(4.1)
Amounts recognised directly in equity		
Deferred tax charge on share based payments	0.1	-

9. DIVIDENDS

	2016 £m	2015 £m
Amounts recognised as distributions to equity holders in the year:		
Base dividend of 43.9p per ordinary share in respect of 2014/15 paid 26 September 2014	–	66.2
Dividend of 22.9p per ordinary share in respect of outperformance for 2013/14 and 2014/15 paid 26 September 2014	–	34.6
Special dividend of 102.7p per ordinary share in respect of outperformance for 2014/15 paid 13 March 2015	–	155.0
Dividend of 12.8p per ordinary share in respect of outperformance for 2014/15 paid 30 September 2015	19.3	–
Base and enhanced dividend of 36.8p per ordinary share in respect of 2015/16 paid 30 September 2015	55.6	–
	74.9	255.8

10. EMPLOYMENT COSTS

The average number of persons (including Executive Directors) employed by the Company was 1,278 (2015: 1,221).

	Note	2016 £m	2015 £m
Wages and salaries		38.9	38.7
Social security costs		3.4	3.3
Pension costs	22	7.3	6.7
Share-based payments		1.1	1.2
Non-underlying items (note 5)		4.7	(11.8)
Total employment costs		55.4	38.1
Charged as follows:			
Employee costs		40.3	39.8
Capital schemes		10.4	10.1
Non-underlying items (note 5)		4.7	(11.8)
Total employment costs		55.4	38.1

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

11. DIRECTORS' EMOLUMENTS

	2016 £000	2015 £000
Executive Directors:		
Salary	732	762
Performance-related bonus paid or payable	257	276
Share-based payments	501	603
Other emoluments, including payments in lieu of pension provision	293	357
Non-executive Directors (including Chairman)	338	277
Total emoluments	2,121	2,275

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 [44] to [61]. This report also details arrangements with Pennon Group Plc for the payment and recharging of emoluments relating to Directors who serve as Directors of both Pennon Group and South West Water. The cost of share-based payments represents the amount charged to the income statement, as described in note 26.

The aggregate gains on vesting of Directors' share-based awards amounted to a total of £209,000.

Total gains made by Directors on the exercise of share options were £nil (2015: £nil).

At 31 March 2016 there was one Director accruing retirement benefits under defined benefit pension schemes (2015: two Directors). At 31 March 2016 there was one Director accruing retirement benefits under defined contribution pension schemes (2015: one) with contributions of £10,350 made during the year (2015: £2,000).

12. PROPERTY, PLANT AND EQUIPMENT

	Freehold land and 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 2014	24.4	1,597.0	649.4	1,321.2	125.1	3,717.1
Additions	0.4	11.5	3.5	34.7	95.0	145.1
Assets adopted at fair value	–	6.8	0.1	0.1	–	7.0
Grants & contributions	–	(1.9)	–	–	–	(1.9)
Disposals	–	(1.2)	(0.1)	(10.4)	–	(11.7)
Transfers/reclassifications	2.6	17.5	4.8	40.3	(65.2)	–
At 31 March 2015	27.4	1,629.7	657.7	1,385.9	154.9	3,855.6
Additions	0.6	15.8	0.5	32.7	76.7	126.3
Assets adopted at fair value	–	6.7	0.8	–	–	7.5
Grants & contributions	–	(5.4)	–	–	–	(5.4)
Disposals	–	(1.2)	–	(2.0)	–	(3.2)
Transfers/reclassifications	7.5	43.0	14.1	73.6	(138.2)	–
At 31 March 2016	35.5	1,688.6	673.1	1,490.2	93.4	3,980.8
Accumulated depreciation:						
At 1 April 2014	6.3	167.1	208.2	740.5	–	1,122.1
Charge for year	0.6	23.8	11.8	71.9	–	108.1
Disposals	–	(1.2)	(0.1)	(10.2)	–	(11.5)
At 31 March 2015	6.9	189.7	219.9	802.2	–	1,218.7
Charge for year	1.1	21.1	11.8	71.1	–	105.1
Disposals	–	(1.2)	–	(1.7)	–	(2.9)
At 31 March 2016	8.0	209.6	231.7	871.6	–	1,320.9
Net book value:						
At 31 March 2014	18.1	1,429.9	441.2	580.7	125.1	2,595.0
At 31 March 2015	20.5	1,440.0	437.8	583.7	154.9	2,636.9
At 31 March 2016	27.5	1,479.0	441.4	618.6	93.4	2,659.9

Out of the total depreciation charge for the Company of £105.1m (2015: £108.1m), the sum of £1.4m (2015: £1.3m) has been charged to capital projects, £0.9m (2015: £0.9m) has been offset by deferred income and £102.8m (2015: £105.9m) against profits.

Asset lives and residual values are reviewed annually. As disclosed in note 2(e) (ii) of these financial statements, with effect from 1 April 2015, the useful lives for certain assets have been amended where both external benchmarking and internal experience indicates a change is required. Lives for some assets have increased whilst others have decreased. To accommodate this change the range of useful lives for water mains and sewers has increased from 100 to 120 years. This has resulted in a net reduction in the total depreciation charge for 2015/16 of £5.1m.

During the year borrowing costs of £1.4m (2015: £2.4m) have been capitalised on qualifying assets, at an average borrowing rate of 3.7%.

12. PROPERTY, PLANT AND EQUIPMENT CONTINUED

Assets held under finance leases included above were:

	Land & buildings £m	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant, vehicles and computers £m	Construction in progress £m	Total £m
Cost:						
At 31 March 2015	–	398.0	422.3	414.0	1.1	1,235.4
At 31 March 2016	–	409.0	432.3	424.6	0.2	1,266.1
Accumulated depreciation:						
At 31 March 2015	–	47.4	96.9	183.2	–	327.5
At 31 March 2016	–	52.6	104.1	203.9	–	360.6
Net book amount:						
At 31 March 2015	–	350.6	325.4	230.8	1.1	907.9
At 31 March 2016	–	356.4	328.2	220.7	0.2	905.5

13. FINANCIAL INSTRUMENTS BY CATEGORY

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

	Note	Fair value Derivatives used for cash flow hedging £m	Amortised cost Loans and receivables £m	Trade receivables and trade payables £m	Total £m
31 March 2016					
Financial assets					
Trade and other receivables	16	–	7.7	103.1	110.8
Derivative financial instruments	17	–	–	–	–
Cash and cash deposits	18	–	251.2	–	251.2
			258.9	103.1	362.0
Financial liabilities					
Borrowings	20	–	(2,044.5)	–	(2,044.5)
Derivative financial instruments	17	(43.7)	–	–	(43.7)
Trade and other payables	19	–	(2.6)	(48.3)	(50.9)
		(43.7)	(2,047.1)	(48.3)	(2,139.1)

13. FINANCIAL INSTRUMENTS BY CATEGORY CONTINUED

		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 2015					
Financial assets					
Trade and other receivables	16	–	10.9	100.0	110.9
Derivative financial instruments	17	0.3	–	–	0.3
Cash and cash deposits	18	–	246.9	–	246.9
		0.3	257.8	100.0	358.1
Financial liabilities					
Borrowings	20	–	(2,064.4)	–	(2,064.4)
Derivative financial instruments	17	(38.5)	–	–	(38.5)
Trade and other payables	19	–	(2.2)	(43.5)	(45.7)
		(38.5)	(2,066.6)	(43.5)	(2,148.6)

14. INVESTMENTS

	2016 £m	2015 £m
At 31 March:		
Subsidiary undertakings	3.3	3.3

The Company has five wholly-owned subsidiaries, Peninsula Properties (Exeter) Limited, Source for Business Limited, South West Water Finance Plc, Source Contact Management Limited and its subsidiary Source Collections Limited. The Company also has a minority shareholding of Landlord Tap Limited. All companies are incorporated, registered and operate in England.

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

In the opinion of the Directors, the total value of the investments in subsidiaries is not less than the amount at which they are shown in the balance sheet.

15. INVENTORIES

	2016 £m	2015 £m
Raw materials and consumables	5.5	5.2

16. TRADE AND OTHER RECEIVABLES – CURRENT

	2016 £m	2015 £m
Amounts receivable from customers	191.8	181.0
Less: provision for impairment of receivables	(88.7)	(81.0)
Net trade receivables	103.1	100.0
Amounts owed by subsidiary companies	–	–
Amounts owed by fellow subsidiary companies	1.3	1.4
Amounts owed by parent undertaking	0.2	0.1
Other receivables	6.2	9.4
Prepayments and accrued income	6.6	8.3
	117.4	119.2

Trade receivables include accrued income relating to customers with metered budget plans.

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:

	2016 £m	2015 £m
Past due 1 - 30 days	12.7	12.9
Past due 31 - 120 days	15.5	15.5
More than 120 days	143.3	131.6

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 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:

	2016 £m	2015 £m
At 1 April	81.0	82.1
Provision for receivables impairment	7.7	9.1
Receivables written-off during the year as uncollectable	(3.5)	(17.3)
Cumulative amounts previously excluded from debt	3.5	7.1
At 31 March	88.7	81.0

17. DERIVATIVE FINANCIAL INSTRUMENTS

	2016 £m	2015 £m
Derivatives used for cash flow hedging:		
Current assets	–	0.1
Non-current assets	–	0.2
Current liabilities	(14.4)	(12.7)
Non-current liabilities	(29.3)	(25.8)

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 (2015: £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 2016, 74% (2015: 63%) of net borrowings was at fixed rate.

At 31 March 2016 interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £978.0 existed, with a weighted average maturity of 4.0 years (2015: £1,003.0m, with 4.4 years). The weighted average interest rate of the swaps was 2.05% (2015: 2.2%).

Valuation hierarchy

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

	2016 £m	2015 £m
Level 2 inputs		
Assets		
Derivatives used for cash flow hedging	–	0.3
Liabilities		
Derivatives used for cash flow hedging	(43.7)	(38.5)

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

18. CASH AND CASH DEPOSITS

	2016 £m	2015 £m
Cash at bank and in hand	1.9	16.8
Other short-term bank deposits	35.3	35.1
Other deposits	214.0	195.0
Cash and cash deposits	251.2	246.9

Overnight deposits have an average maturity of one day. Other short-term bank deposits have an average maturity of 66 days.

Other deposits include £214.0m (2015: £195.0m) of restricted funds to settle long-term lease liabilities (note 20).

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

	2016 £m	2015 £m
Cash and cash deposits as above	251.2	246.9
Less: deposits with a maturity of three months or more (restricted funds)	(214.0)	(195.0)
Cash and cash equivalents	37.2	51.9

19. TRADE AND OTHER PAYABLES – CURRENT

	2016	2015
	£m	£m
Trade payables	48.3	43.5
Amounts owed to subsidiary companies	2.6	2.2
Other tax and social security	1.4	1.3
Other payables	7.7	7.8
Accruals	18.1	19.2
Deferred income	1.2	1.1
	<u>79.3</u>	<u>75.1</u>

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

20. BORROWINGS

	2016	2015
	£m	£m
Current		
Loan from parent company	50.0	130.0
European Investment Bank	38.7	31.1
	<u>88.7</u>	<u>161.1</u>
Obligations under finance leases	15.9	22.7
Total current borrowings	<u>104.6</u>	<u>183.8</u>
Non-current		
European Investment Bank	234.4	273.2
Other external loans	80.0	–
Loan from subsidiary company (note 33)	394.9	391.8
	<u>709.3</u>	<u>665.0</u>
Obligations under finance leases	1,230.6	1,215.6
	<u>1,939.9</u>	<u>1,880.6</u>
Total borrowings	<u>2,044.5</u>	<u>2,064.4</u>

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

The fair value of the non-current borrowings were:

	2016		2015	
	Book value £m	Fair value £m	Book value £m	Fair value £m
European Investment Bank	234.4	209.3	273.2	250.6
Other external loans	80.0	80.0	–	–
Loan from subsidiary company	394.9	418.4	391.8	403.3
	<u>709.3</u>	<u>707.7</u>	<u>665.0</u>	<u>653.9</u>
Obligations under finance leases	1,230.6	1,083.5	1,215.6	1,093.3
	<u>1,939.9</u>	<u>1,791.2</u>	<u>1,880.6</u>	<u>1,747.2</u>

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

20. BORROWINGS CONTINUED

The maturity of non-current borrowings was:

	2016 £m	2015 £m
Between 1 and 2 years	57.6	55.4
Over 2 and less than 5 years	181.1	197.6
Over 5 years	1,701.2	1,627.6
	1,939.9	1,880.6

The weighted average maturity of non-current borrowings was 25 years (2015: 25 years).

Finance lease liabilities – minimum lease payments:

	2016 £m	2015 £m
Within 1 year	31.4	40.0
Over 1 year and less than 5 years	191.3	209.0
Over 5 years	2,076.1	2,105.3
	2,298.8	2,354.3
Less: future finance charges	(1,052.3)	(1,116.0)
Present value of finance lease liabilities	1,246.5	1,238.3

The maturity of finance lease liabilities was:

	2016 £m	2015 £m
Within 1 year	15.9	22.7
Over 1 year and less than 5 years	95.6	114.2
Over 5 years	1,135.0	1,101.4
	1,246.5	1,238.3

Included above are accrued finance charges arising on obligations under finance leases totalling £137.7m (2015: £132.8m), of which £0.5m (2015: £2.9m) is repayable within one year.

Included above is £0.6m (2015: £0.6m) due to Peninsula Leasing Limited (a fellow Pennon Group subsidiary), under finance lease agreements of which £0.3m (2015: £0.3m) is repayable within one year.

Within obligations under finance leases, the Company had some obligations under finance leases which were secured by bank letters of credit issued by United Kingdom financial institutions. These letters of credit, covering the full period of the finance leases, were renegotiated and cancelled as part of lease restructuring.

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 £71.7m at 31 March 2016 (2015: £70.7m) are being held to settle the lease liability over the period from the end of the original lease term. The deposits are subject to a registered charge given as security to the lessor for the balance outstanding.

The period for repayment of certain 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 2016 of £142.3m (2015: £124.3m) 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:

	2016 £m	2015 £m
Floating rate:		
Expiring within one year	50.0	25.0
Expiring after one year	635.0	425.3
	685.0	450.3

In addition, the company has undrawn uncommitted short-term bank facilities of £25.0m (2015: £25.0m).

21. OTHER NON-CURRENT LIABILITIES

	2016 £m	2015 £m
Deferred income	80.5	74.3

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

22. 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 £1.9m (2015: £0.9m).

Defined benefit schemes

The principal actuarial assumptions at 31 March 2016 were:

	2016 %	2015 %	2014 %
Rate of increase in pensionable pay	2.9	2.9	3.4
Rate of increase for current and future pensions	2.8	2.9	3.2
Rate used to discount schemes' liabilities and expected return on scheme assets	3.30	3.35	4.30
Inflation	2.9	2.9	3.4

Mortality

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:

	2016	2015	2014
Male	25.1	25.0	24.9
Female	27.3	27.2	27.1

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

	2016	2015	2014
Male	26.5	26.4	26.3
Female	29.6	29.5	29.4

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%	+/- 0.1%
Rate of increase in current and future pensions	+/- 0.5%	+/- 6.2%
Rate used to discount schemes' liabilities	+/- 0.5%	+/- 9.4%
Inflation	+/- 0.5%	+/- 6.3%
Life expectancy	+/- 1 year	+/- 3.6%

22. RETIREMENT BENEFIT OBLIGATIONS CONTINUED

Defined benefit schemes continued

The amounts recognised in the balance sheet were:

	2016 £m	2015 £m
Present value of financial obligations	(500.8)	(501.8)
Fair value of plan assets	471.2	460.3
Deficit of funded plans	(29.6)	(41.5)
Impact of minimum funding asset ceiling	-	-
Net liability recognised in the balance sheet	(29.6)	(41.5)

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

	2016			2015		
	Present value of obligation £m	Fair value of plan assets £m	Total £m	Present value of obligation £m	Fair value of plan assets £m	Total £m
At 1 April	(501.8)	460.3	(41.5)	(465.5)	404.7	(60.8)
Current service cost	(5.4)	-	(5.4)	(5.7)	-	(5.7)
Interest (expense)/income	(16.6)	15.2	(1.4)	(19.3)	17.2	(2.1)
Past service cost and gains and losses on settlements	-	-	-	11.5	-	11.5
	(22.0)	15.2	(6.8)	(13.5)	17.2	3.7
Remeasurements:						
Return on plan on assets excluding amounts included in interest expense	-	(8.7)	(8.7)	-	42.6	42.6
Gain/(loss) from change in demographic assumptions	-	-	-	13.3	-	13.3
(Loss)/Gain from change in financial assumptions	-	-	-	(57.2)	-	(57.2)
Experience gains	5.1	-	5.1	3.0	-	3.0
	5.1	(8.7)	(3.6)	(40.9)	42.6	1.7
Contributions:						
Employers	-	22.3	22.3	-	13.9	13.9
Plan participants	(0.1)	0.1	-	(0.1)	0.1	-
Payments from plans:						
Benefit payments	18.0	(18.0)	-	18.2	(18.2)	-
	17.9	4.4	22.3	18.1	(4.2)	13.9
At 31 March	(500.8)	471.2	(29.6)	(501.8)	460.3	(41.5)

Employer contributions are made into the scheme by South West Water and other companies within the Pennon Group based upon pensionable pay of employees in each section of the scheme. Full details of the scheme are included within the Pennon Group Plc financial statements (see note 30).

22. RETIREMENT BENEFIT OBLIGATIONS CONTINUED

Defined benefit schemes continued

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

	2016		2015
	Quoted prices in active market £m	Fund %	Quoted prices in active market £m
			Fund %
Equities	141.3	30	152.0
Property	39.8	8	35.4
Bonds	175.1	37	143.8
Diversified Growth Fund	55.4	12	56.2
Other	59.6	13	72.9
	471.2	100	460.3
			100

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

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 scheme's 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 scheme's 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 scheme's 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 2013. The Company has made a deficit recovery contribution to the main scheme during the year of £18.3m (2015: £8.7m). The Pennon Group monitors funding levels on an annual basis and South West Water expects to pay total contributions of around £8.9m during the year ended 31 March 2017.

Deficit recovery contributions are made as agreed and by dates in the recovery plan, split between South West Water and other companies within the Pennon Group based upon the number of scheme members from each company.

23. DEFERRED TAX LIABILITIES

Deferred tax is provided in full on temporary differences under the liability method using the enacted tax rates.

The movements on deferred tax were:

	2016 £m	2015 £m
At 1 April	232.2	227.9
Impact of change of corporation tax rate credited to the income statement	(26.8)	–
Impact of change of corporation tax rate charged to other comprehensive income	2.9	–
Impact of change of corporation tax rate charged to equity	0.1	–
Other deferred tax charged to the income statement	5.5	8.0
Credited to other comprehensive income / equity	(2.1)	(3.7)
At 31 March	211.8	232.2

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 credit of £23.8m to recognise the changes in the rate of corporation tax enacted on 18th November 2015 to reduce the rate at 1 April 2017 from 20% to 19%, followed by a further reduction from 1 April 2020 to 18%. This credit includes a credit of £26.8m recognised in the income statement and a debit of £3.0m recognised in the statement of comprehensive income and equity. If the Government proposals contained in the Finance Bill 2016 to reduce the rate of corporation tax by a further 1% for the financial year 2021 (2% reduction in total) had been enacted at the balance sheet date, the impact would have been a further reduction of approximately £11.8m.

The movements in deferred tax assets and liabilities were:

Deferred tax liabilities

	Accelerated tax depreciation £m
At 31 March 2014	245.0
Charged to the income statement	3.9
At 31 March 2015	248.9
Charged to the income statement	2.9
Non underlying credited to the income statement	(25.5)
At 31 March 2016	226.3

23. DEFERRED TAX LIABILITIES CONTINUED

Deferred tax assets

	Provisions £m	Retirement benefit obligations £m	Derivatives £m	Share based payments £m	Total £m
At 31 March 2014	(1.4)	(12.2)	(2.7)	(0.8)	(17.1)
Charged to the income statement	0.5	3.5	–	0.1	4.1
Charged/(credited) to other comprehensive income / equity	–	0.4	(4.1)	–	(3.7)
At 31 March 2015	(0.9)	(8.3)	(6.8)	(0.7)	(16.7)
(Credited)/charged to the income statement	(0.5)	3.1	–	–	2.6
Non-underlying charged/(credited) to the income statement	0.2	(1.5)	–	–	(1.3)
Credited to other comprehensive income	–	(0.7)	(1.4)	–	(2.1)
Non-underlying charged to equity/ other comprehensive income	–	2.1	0.8	0.1	3.0
At 31 March 2016	(1.2)	(5.3)	(7.4)	(0.6)	(14.5)

Net deferred tax liability

	£m
At 31 March 2015	232.2
At 31 March 2016	211.8

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

	2016 £m	2015 £m
Actuarial gains on defined benefit schemes	1.4	0.4
Share-based payments	0.1	–
Cash-flow hedges	(0.6)	(4.1)
	0.9	(3.7)

24. PROVISIONS

	2016 £m	2015 £m
Restructuring		
At 1 April	2.0	2.4
Charged to the income statement	5.2	0.5
Utilised during year	(0.5)	(0.9)
At 31 March	6.7	2.0

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

25. CALLED UP SHARE CAPITAL

	2016 £m	2015 £m
Authorised 500,000,000 (2015: 500,000,000) Ordinary shares of £1 each	500.0	500.0
Allotted and fully paid 150,950,000 (2015: 150,950,000) Ordinary shares of £1 each	150.9	150.9

26. 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	Subscription price fully paid	Period when options normally exercisable	Thousands of shares in respect of which options outstanding at 31 March	
			2016	2015
8 July 2008	517p	2011 – 2015	–	5
6 July 2009	386p	2012 – 2016	23	23
28 June 2010	431p	2013 – 2017	28	108
29 June 2011	536p	2014 – 2018	69	70
29 June 2012	588p	2015 – 2017	35	279
3 July 2013	538p	2016 – 2018	271	283
14 July 2014	611p	2017 – 2019	296	312
24 June 2015	683p	2018 – 2020	602	–
			1,324	1,080

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

	2016		2015	
	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	1,080	558	1,140	511
Granted	620	683	319	611
Exercised	(326)	548	(307)	454
Expired	(50)	617	(72)	492
At 31 March	1,324	617	1,080	558

The weighted average price at the date of exercise of Sharesave options during the year was 779p (2015: 811p). The options outstanding at 31 March 2016 had a weighted average exercise price of 617p (2015: 558p) and a weighted average remaining contractual life of 2.1 years (2015: 1.8 years).

26. EMPLOYEE SHARE SCHEMES CONTINUED

i) Sharesave Scheme continued

The aggregate fair value of Sharesave options granted during the year was £0.8m (2015: £0.3m), determined using the Black-Scholes valuation model. The significant inputs into the valuation model, at the date of issue of the options, were:

	2016	2015
Weighted average share price	854p	764p
Weighted average exercise price	683p	611p
Expected volatility	17.0%	17.0%
Expected life	3.4 years	3.4 years
Risk-free rate	0.8%	1.4%
Expected dividend yield	4.0%	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:

	2016		2015	
	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	357	735	357	703
Granted	119	810	113	799
Vested	-	769	(34)	698
Lapsed	(110)	769	(79)	698
At 31 March	366	749	357	735

The awards outstanding at 31 March 2016 had a weighted average exercise price of 749p (2015: 735p) and a weighted average remaining contractual life of 1.8 years (2015: 1.3 years).

The aggregate fair value of awards granted during the year was £0.5m (2015: £0.5m), determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were:

	2016	2015
Weighted average share price	811p	795p
Expected volatility	17.0%	17.0%
Risk-free rate	0.8%	1.4%

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

26. EMPLOYEE SHARE SCHEMES CONTINUED

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:

	2016		2015	
	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	149	758	148	698
Granted	62	791	51	822
Vested	(51)	755	(50)	573
At 31 March	160	768	149	758

The awards outstanding at 31 March 2016 had a weighted average price of 768p (2015: 758p) and a weighted average remaining contractual life of 2.4 years (2015: 1.3 years). The Group's share price at the date of the awards ranged from 713p to 897p.

The aggregate fair value of awards granted during the year was £0.5m (2015: £0.4m), determined from market value. No option pricing methodology is applied since dividends declared on the shares are receivable by the participants in the scheme.

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

27. RETAINED EARNINGS AND OTHER RESERVES

	Hedging reserve £m	Retained earnings £m	Total £m
At 31 March 2014	(7.9)	443.9	436.0
Profit for the year	–	141.9	141.9
Other comprehensive loss for the year	(19.4)	1.3	(18.1)
Dividends paid	–	(255.8)	(255.8)
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	–	0.5	0.5
At 31 March 2015	(27.3)	332.7	305.4
Profit for the year	–	160.0	160.0
Other comprehensive loss for the year	(6.5)	(5.0)	(11.5)
Dividends paid	–	(74.9)	(74.9)
Share-based payments (including tax)	–	1.2	1.2
Pennon shares disposed on vesting of options	–	(0.7)	(0.7)
At 31 March 2016	(33.8)	413.3	379.5

The hedging reserve is used to record the portion of the gain or loss on a hedging instrument in a cash flow hedge that is determined to be an effective hedge.

28. CASH FLOW FROM OPERATING ACTIVITIES

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

	2016 £m	2015 £m
Continuing operations		
Profit for the year	160.0	141.9
Adjustments for:		
Share based payments	1.1	1.2
Deferred income released to profits	(0.2)	(0.2)
Profit on disposal of property, plant and equipment	(1.3)	(1.1)
Depreciation charge	102.8	105.9
Finance income	58.2	60.4
Finance charge	(2.8)	(2.8)
Taxation	(5.6)	37.8
Non underlying defined benefit pension credit	–	(11.8)
Non underlying provision charge	5.2	–
Changes in working capital:		
Increase in inventories	(0.3)	(0.8)
Decrease / (increase) in trade and other receivables	1.5	(7.8)
(Decrease) / increase in trade and other payables	(2.6)	1.1
Decrease in retirement benefit obligations	(16.9)	(7.9)
Decrease in provisions	(0.6)	(0.4)
Cash generated from operations	298.5	315.5

29. NET BORROWINGS

	2016 £m	2015 £m
Cash and cash deposits	251.2	246.9
Borrowings – current		
Loan from parent company	(50.0)	(130.0)
Other current borrowings	(38.7)	(31.1)
Finance lease obligations	(15.9)	(22.7)
Total current borrowings	(104.6)	(183.8)
Borrowings – non-current		
Other non-current borrowings	(709.3)	(665.0)
Finance lease obligations	(1,230.6)	(1,215.6)
Total non-current borrowings	(1,939.9)	(1,880.6)
Total net borrowings	(1,793.3)	(1,817.5)

30. OPERATING LEASE COMMITMENTS

The future aggregate minimum lease payments under non-cancellable operating leases are:

	2016 £m	2015 £m
Within 1 year	1.5	1.5
Over 1 year and less than 5 years	5.4	5.4
Over 5 years	17.8	18.9
	24.7	25.8

31. CONTINGENT LIABILITIES

	2016 £m	2015 £m
Guarantee of borrowings of subsidiary undertaking	385.5	382.6

Guarantees in respect of performance bonds, the last of which expire in 2057 and which will be reduced in line with repayments of the borrowings of the subsidiary undertaking, are entered into in the normal course of business. No liability is expected to arise in respect of the guarantees.

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.

Significant management judgement is required to estimate the tax provisions relating to uncertain tax items that remain to be agreed with HMRC. It is reasonably possible that the outcomes and settlements may differ from the estimated current tax liabilities shown in the consolidated balance sheet. Due to the uncertainty associated with such tax items, it is possible that at a future date, on conclusion of the open matters, the final outcome may vary significantly.

32. CAPITAL COMMITMENTS

	2016 £m	2015 £m
Contracted but not provided	69.2	65.6

33. RELATED PARTY TRANSACTIONS

	2016 £m	2015 £m
Parent company		
Purchase of goods and services		
– Group expenses	4.9	4.5
Payment for provision of finance		
- Loan interest	1.0	0.1
Sale of goods and services		
– Administrative services	0.4	0.5
Dividends paid	74.9	255.8
	2016 £m	2015 £m
Subsidiaries of the Company		
Purchase of goods and services		
– Property consultancy	0.2	0.2
– Billing and collection services	9.3	9.3
Payment for provision of finance		
– Loan interest	12.4	12.9
Sale of goods and services (administrative services)	1.4	1.5
	2016 £m	2015 £m
Fellow subsidiaries of the Pennon Group		
Purchase of goods and services		
– Insurance premia	0.3	0.3
Payment for provision of finance		
– Finance lease charges: vehicles	-	0.1

33. RELATED PARTY TRANSACTIONS CONTINUED

	2016	2015
	£m	£m
Year end balances		
Borrowings		
– Loan from parent	50.0	130.0
– Loan from subsidiary	394.9	391.8
– Finance lease balances with fellow subsidiary	-	0.7
Receivables		
– Parent company	0.2	0.1
– Fellow subsidiaries	0.3	0.1
Payables		
– Subsidiaries	2.6	2.3

Details of the £50.0m loan from the parent Company, Pennon Group Plc, are included in note 20.

34. POST BALANCE SHEET EVENT

On 1 April 2016, South West Water Limited acquired the entire share capital of Bournemouth Water Investments Limited, a company incorporated in the United Kingdom for a total consideration of £104m, satisfied through Pennon Group Plc purchasing an additional £100m of new share capital in South West Water Limited and transferring a £4m loan due to Bournemouth Water Limited to South West Water Limited.

Following the transfer, the trade and assets from Bournemouth Water Investments Limited's subsidiary companies have been transferred into South West Water Limited at book value. The consideration was satisfied by the payment of a dividend from Bournemouth Water Investments Limited to South West Water Limited.

35. PARENT COMPANY

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