

COMPANY NO: 02366665

**SOUTH WEST WATER LIMITED**

**ANNUAL REPORT AND FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 31 MARCH 2017**



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# CHAIRMAN'S STATEMENT

South West Water has performed well in the year delivering on its strategy of market-leading performance. It has delivered this across both the original South West Water and Bournemouth Water areas. The Company's return on regulatory equity (RORE) remains sector leading.

We continue to invest to improve services to our customers and the environment. Construction work is progressing well in Plymouth on the new £60m Mayflower Water Treatment Works, which will use cutting edge treatment processes, achieving high quality drinking water, developing better resilience in the Plymouth area and improving efficiency.

I believe that the Company is well placed to continue its strong performance, maintaining its sector leading RORE throughout this regulatory period until 2020, while continuing its strong operational performance and investing to deliver further significant operational improvements in both areas.

## SAFETY

The position of health and safety is the first item on the agenda for every Board meeting and reflects the importance my colleagues and I attach to this crucial area. It also underlines our determination to increase employee engagement, address the culture and behaviours that lead to accidents and learn all relevant lessons for the future from any incident.

We strive for the highest standards of health and safety to achieve our objective of a harm free environment. South West Water and the entire Pennon Group are committed to providing a safe place for our people to work where health and wellbeing comes first, ensuring all our people return home safe every day.

## 2016/17 PERFORMANCE SUMMARY

In the second year of our K6 business plans, significant performance improvements have been made in both the original South West Water and Bournemouth Water areas. South West Water has 23 Outcome Delivery Incentives (ODIs) and Bournemouth Water has 10, which have potential financial rewards or penalties. In both areas, these ODIs include the Service Incentive Mechanism (SIM), an industry wide measure of customer satisfaction. There are further ODIs which are reputational and do not have potential financial rewards or penalties.

For a 20<sup>th</sup> successive year, there were no water restrictions in the South West Water area, with Bournemouth Water maintaining its record of no water restrictions since privatisation in 1989. For the second year in a row, no bathing waters in the South West Water region failed the more challenging EU bathing water standards due to the failure or underperformance of South West Water's assets. South West Water maintained stable reliability and serviceability across all four areas of operations and performance in respect of interruptions to supply and leakage improved during the year.

Despite our best performance in compliance, performance in wastewater pollutions and external flooding did not achieve our targeted commitments, although the number of 'significant' pollution incidents (Category 1 and 2) fell. Overseen by its 'Outcome Delivery Incentive Board,' South West Water is taking action to further improve performance in areas which have not met commitment targets.

The strong operating performance led to an overall net ODI reward of £3.6m for the year.

## **BOURNEMOUTH WATER**

Bournemouth Water's operations and licence were merged into South West Water on 1 April 2016 and the integration process has progressed well with a new management structure in place. The transaction is described in note 16 to the financial statements.

Synergies have been, and will continue to 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 and capital construction efficiencies.

We have delivered continued improved service performance in both operational areas.

## **NON-HOUSEHOLD MARKET OPENING**

Ahead of the non-household retail market opening on 1 April 2017, and as part of an extensive internal programme of preparation, South West Water engaged fully in a period of 'shadow operation' to ensure it was ready for the opening of the market. Business customers are now able to choose which retailer they buy their services from and South West Water no longer provides non-household retail services following the establishment of Pennon Water Services (a legally separate fellow Group company).

We worked hard to ensure that customer service was maintained throughout the preparations for market opening, including shadow operation.

## **FINANCIAL PERFORMANCE**

Following the merger of the Bournemouth Water business into South West Water, the water business recorded strong performances, outperforming regulatory assumptions. Profit before tax increased by 12.0% to £172.9m, which includes the impact of acquiring Bournemouth Water. EBITDA increased during the year due to higher revenue and cost efficiencies along with other cost reductions.

South West Water's bad debt charge continues to fall, down by over a quarter over the last two years to 1.1% as a percentage of revenue (1.5% for 2015/16). This was driven by strong collections as we work with our customers to manage their debt, with operations continually updating their approaches in targeting those customers with the means to pay, whilst supporting those who have genuine affordability challenges.

South West Water's capital additions were £190.9m compared to £134.1m (including Bournemouth Water) in 2015/16. The beginning of the new regulatory period last year reflected a change in the nature and extent of capital activity and there has been a significant increase in activity this year, including the commencement of the £60m Mayflower Water Treatment Works, which is the largest single capital investment in the five year business plan.

## **SUSTAINABILITY**

Environment, social and governance 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, continued excellent performance against EU bathing water standards, commencement of construction 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, continuation of our award winning 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 53 to 56.

## **BOARD DEVELOPMENTS**

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. They bring with them a wealth of industry, financial and governance experience, which complements existing experience held by South West Water Board members.

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.

## **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 within South West Water. Following Non-executive Director appointments on 1 April 2016, the proportion of female Directors has increased to 22%. South West Water remains committed to increasing female representation on the Board.

More information on the Board's diversity policy can be found within the Nomination Committee's report, on page 58.

## **OUTLOOK**

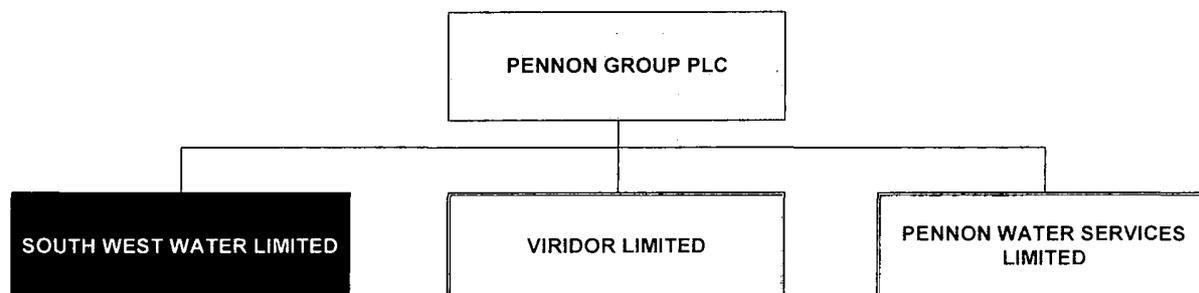
South West Water has performed well in this second year of the K6 regulatory period (2015-20). South West Water is well placed to deliver outperformance of the business plan whilst developing our people, delivering strong customer service, protecting the environment and helping the communities in which we operate in both the South West and the Bournemouth areas.

South West Water has been fully engaged in Ofwat's Water 2020 forward programme and as the methodology and mechanisms for the 2020-25 periodic review (PR19) are developed and will continue to be so. Whilst lower base returns are expected in the next regulatory price review, we expect these to be balanced with greater incentives for outperformance for top performing companies. The Company is also in a good position to manage changes in the methodology.

In addition, South West Water will be publishing our 25 year strategic plan later this year which will again focus on our customer priorities following extensive customer engagement, our strong operational performance and longer term plans for improving our resilience, reliability and responsiveness.

## SOUTH WEST WATER'S GROUP CONTEXT

South West Water Limited is a subsidiary of Pennon Group Plc, a FTSE 250 company, whose principal significant trading subsidiaries are shown as follows:



Note: this is a summary structure and excludes smaller, non-externally trading subsidiaries. South West Water's subsidiaries are described in note 16 (page 127).

### *SOUTH WEST WATER*

South West Water provides regulated water and wastewater services across Cornwall, Devon and parts of Dorset and Somerset, in addition to a small amount of non-appointed services. From 1 April 2016 the trade and assets of Bournemouth Water were merged into South West Water Limited. Bournemouth Water's licence as a water only undertaker under the Water Act 1991 was terminated and South West Water's licence was modified to cover the Bournemouth Water area. South West Water Limited is therefore now responsible for delivering the business plans in both the original South West Water area of operation and the Bournemouth Water area of operation (covering areas of Dorset, Hampshire and Wiltshire).

### *VIRIDOR*

Viridor provides waste management services to UK residential and commercial customers including recycling, composting and energy recovery facilities.

### *PENNON WATER SERVICES*

Pennon Water Services was established as a Pennon subsidiary in 2015 and from 1 April 2017 has provided retail services to non-household customers following the opening of the non-household retail market. During 2016/17 it provided management services to South West Water in respect of South West Water's non-household retail customers as we prepared for market opening.

Whilst part of the wider Pennon Group, South West Water and Pennon Water Services have in place robust policies and practises to ensure full competition compliance with the market codes for the non-household retail market.

### *PENNON GROUP PLC*

As a result of this group structure South West Water, along with the other subsidiaries, align our governance framework with that of the Pennon Board. Further information on the approach to Group and South West Water governance is included in pages 31 to 63.

# SOUTH WEST WATER'S BUSINESS MODEL

We manage our business to deliver value to our customers and investors. 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 and ultraviolet disinfection to improve water quality.

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 to benefit agriculture
- energy generation from treatment processes through Combined Heat and Power (CHP) and solar panels.

## 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 wastewater 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

- 2.2m total population served
- 1.0m customers served
- 23 raw water reservoirs
- 36 water treatment works
- 18,131km of drinking water mains network
- 653 wastewater treatment works
- 15,600km wastewater mains network
- 900 wastewater pumping stations
- 144 bathing waters and 24 shellfish waters

## CONTINUING OUTPERFORMANCE AGAINST THE K6 REGULATORY CONTRACT (2015-2020)

South West Water, which since 1 April 2016 includes Bournemouth Water, performed well during the year. South West Water's Return on Regulated Equity (RORE)<sup>1</sup> performance continues to be sector leading and is outperforming its business plan with 12.6% delivered in the year.

South West Water's RORE is expected to be at a sector-leading level through to 2020. The 12.6% RORE arises from base, financing and operational returns with 6.0% as the base return, 3.2%<sup>2</sup> reflecting total expenditure savings and efficiencies, 0.3% reflecting a net reward on Outcome Delivery Incentives (ODIs) and 3.1%<sup>3</sup> reflecting the difference between actual and assumed financing costs using a cumulative forecast RPI over K6 and is consistent with the approach adopted for calculating our innovative WaterShare mechanism.

During the year Ofwat issued additional guidance to companies which requires financing outperformance to be calculated using an in-year average RPI rate<sup>4</sup>. This approach reflects a financing outperformance of 2.4% and a total RORE of 11.9% for 2016/17 (2015/16: 1.4% and 10.1% respectively). South West Water's RORE would remain sector-leading and by the end of K6 period overall performance will converge.

A key highlight for the year is our significant capital investment of £190.9m in our drinking water and wastewater operations. This is part of a concerted push to enhance our environmental performance and services to customers. We are pleased with the improvements seen during the year.

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<sup>1</sup> RORE reflects Base RORE plus Outperformance. It is calculated using actual results before non-underlying items (deflated into 2012/13 prices) and compared against the Final Determination allowances and based on notional gearing, annual average RCV and reflecting the value of tax impacts at the actual annual effective tax rate for the year.

<sup>2</sup> Includes integration synergies already delivered. 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.

<sup>3</sup> Interest outperformance is based on the outturn effective interest rate on net debt, translated into an effective real interest rate using cumulative K6 forecast RPI of 2.8%, notional debt gearing of 62.5%, and actual effective tax rates.

<sup>4</sup> Average RPI of 2.1% for 2016/17 and 1.1% for 2015/16.

### *TOTAL EXPENDITURE (TOTEX) SAVINGS*

South West Water continues to focus on driving value through efficiency. It achieved further total expenditure (Totex) savings resulting in cumulative savings of £129m and financing outperformance of £67m in the first two years of K6 (2015-2020). The business expects to remain at the forefront of cost efficiency for the water sector.

These savings were driven by continuing advantages from our strategic alliances, including a new water distribution framework and our H<sub>2</sub>O capital alliance, which is now also delivering efficient schemes within the Bournemouth region. We are also ensuring efficient capital investment, promoting efficient off-site build techniques and changing the way we work through our iOPS programme, focused on innovation and new technology to deliver cost efficiency and customer service improvements.

We continue to deliver synergies from the merger of Bournemouth Water's operations into South West Water, focusing on front-line functions in 2016/17, having completed integration of back-office and support services at the end of the prior year. The targeted c.£27m of net synergies over K6 are on track.

### *DELIVERING NET ODI REWARD*

South West Water has 23 ODIs and Bournemouth Water 10 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 has continued to improve and performance for the year results in the delivery of a net ODI reward of £3.6 million (£5.5 million cumulatively) reflecting RORE outperformance of 0.3% for the year. Good asset reliability with stable serviceability across all water and wastewater areas has been maintained. Rewards were delivered across bathing water quality, water restrictions with interruptions to supply and leakage showing a significant improvement from the 2015/16 position.

The cumulative net reward of £5.5 million comprises £7.5 million of net rewards recognised at the end of the regulatory period and £2.0 million of net penalty which could be adjusted during the regulatory period.

Whilst penalties have arisen on pollution events and external flooding ODIs wastewater continues to be an area of focus and performance to date has improved from last year.

Whilst Bournemouth Water has been fully integrated into South West Water with all financial elements combined, we have committed to retaining separate operational targets set within Bournemouth Water's business plan for 2015-20.

### *FINANCING INVESTMENT EFFICIENTLY*

Alongside strong operational outperformance, South West Water is confident that the efficient and effective financing strategy in place will continue to deliver cumulative K6 financing outperformance, with £67 million delivered in the K6 period to 31 March 2017. The effective interest rate in South West Water has remained broadly stable in the year with continued focus on maintaining efficient gearing levels, having a good balance of fixed and floating rate debt and continuing to implement cost efficient debt through finance leasing.

## **DRINKING WATER**

Drinking water quality is a key priority and we maintained the high standards set previously. South West Water achieved 99.96%<sup>5</sup> in the South West area and 99.98%<sup>5</sup> in the Bournemouth region.

The improved performance in managing our network led to South West Water's improved leakage result of 82ML per day, exceeding our original target and delivering an ODI reward. This reflects innovative approaches to network management including investment in real-time pressure management, detection, repairs and network monitoring. Leakage in the Bournemouth region was 19ML per day (in line with the 2020 target of 20ML per day).

This was our 20<sup>th</sup> consecutive year of unrestricted water supplies in the South West area and the Bournemouth region maintained its record of zero water restrictions since privatisation.

The average duration of supply interruptions per property for the original South West Water region was lower than 2015/16. This performance delivered a small reward for the year compared to the penalty incurred in 2015/16. For the Bournemouth Water area there was a significant reduction in the average duration of supply interruptions.

We have continued to invest in our assets to deliver drinking water quality improvements. The new £60 million state-of-the-art Mayflower Water Treatment Works in Plymouth is the largest single item of capital expenditure in our current five-year plan. Serving Plymouth and South Devon, this is a major construction and engineering project with the facility scheduled to open in 2018. During the year, we reached the halfway point in the build on time and on budget. Mayflower will be one of only two plants in the world to use transformational ceramic membrane filter technology.

Construction of three modern plants using Granulated Activated Carbon (GAC), a sophisticated filter technology for improved water treatment, is underway and progressing well at Tottiford, Tamar Lakes and Northcombe.

There was continued investment in our award winning Upstream Thinking programme of catchment management involving a range of stakeholders including wildlife trusts and river authorities. The programme has worked with 1,056 farms to improve 7,568 acres of upstream land.

## **WASTEWATER**

South West Water aims to ensure the safe and efficient removal and disposal of wastewater while minimising the possibility of sewer flooding and pollution. We also continued to implement a programme of wastewater treatment improvements and increased monitoring to prevent potential failure.

This delivered a significant improvement and best ever performance in numeric compliance (the percentage of wastewater treatment works deemed compliant). Performance for the year was 98.4% compared to 95.8% in the previous year. Our performance at our smaller (descriptive) sites was 99.4% compared to 99.1% last year

Significant incidents (Categories 1 to 2) continued to fall, however the number of minor (Category 3 and 4) incidents increased marginally to 252 (2015: 222). Unfortunately, the number of significant incidents at four is higher than target and, although lower than the seven reported last year, will result in a penalty for the year. We are prioritising further improvement in this area of our wastewater operations.

We delivered record bathing water quality results against more stringent EU standards during the year. Of the 143 bathing waters tested in the South West Water Region, 141 (98.6%) were classified as 'sufficient' or better.

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<sup>5</sup> As measured by Mean Zonal Compliance (MZC)

More than 116 beaches (81.1%) were classified as 'excellent'. All of Cornwall's beaches passed and only two beaches in Devon failed with neither of these due to any failure on the part of South West Water's own assets. These bathing water results are critically important given the importance of the coastal environment to the region's economy.

Highlights of our investments and activity in wastewater during the year include process improvements and upgrades at four key sites and improvements in the sewerage network to reduce the impact of saline infiltration (the impact of salt water). We also invested in increased capacity at our wastewater treatment works at Fluxton in Devon and Hayle in Cornwall.

Our continued investment in sustainability includes £5m as part of our Downstream Thinking programme, which seeks to reduce sewer flooding by improving urban drainage, and £20m for improvements in bathing waters and shellfish waters around Plymouth.

We also invested over £1m in partnership with the Environment Agency and the local lead flood authority to support the Exeter Flood Defence Scheme at Countess Wear Wastewater Treatment works. This is a welcome opportunity to work with partners in the region to enhance sustainability and deliver more resilient services.

Furthermore, we continue to target a reduction in sewer flooding and pollution through the promotion of responsible sewer usage with our customers.

Following the success of our award-winning 'Love Your Loo' campaign, which targeted communities in areas with a history of sewer blockages, we launched a new 'Think Sink' campaign in December 2016. This encourages customers to 'take the pledge' and avoid disposing of fat, oil and grease (among the major contributors to blockages) down the drain.

## 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 the quality of life, communities and the regional economies in both the original South West Water and Bournemouth Water areas.

### 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 saw another improvement in the first time resolution 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 website is being launched to further enhance website functionality.

In response to our 'risks, strengths and weaknesses' and 'assurance plan' consultations, South West Water has made a number of commitments to meet customer and other stakeholders' needs. This includes enhancements to annual reporting including publication of a new 'Summary Performance Report.'

## **CUSTOMER SERVICE AND ENGAGEMENT**

There was a significant improvement in our customer service performance during the year.

South West Water scored 81.6 under the SIM (Service Incentive Mechanism) used by Ofwat to compare water company performance. The score for 2016/17 continues the improving trend of recent years and compares well with the previous year's score of 78.6. This reflects good progress in how we deal with service issues as well as call centre investments in data analytics and call handler training. Bournemouth Water's SIM score was 86.3 in 2016/17, one of the highest in the industry.

The improved SIM scores owes much to the approximately 30% reduction in written complaints received. The customer experience quality scores also improved across both regions during the year. In addition, our overall customer satisfaction was 89% in line with last year and customer satisfaction with value-for-money was at an all-time high, with customer bills reducing in real terms over the 2015-20 regulatory period.

### *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 the Citizens Advice Bureau. We implemented a new employee training and development programme during the year that further extends our support for vulnerable customers.

The Company was one of the first water companies to introduce a social tariff to help customers experiencing temporary or long-term problems in paying their water bills. For 2017/18, South West Water has also introduced a social tariff in the Bournemouth area for the first time.

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. This has resulted in a continued increased uptake of affordability schemes, increased metering and customer debt reduction.

### *WATERSHARE*

Our unique WaterShare scheme identified £4.5m of benefits to customers during the year under review. This is in addition to the £3.1m shared in 2015/16. Following discussions with the independent WaterShare panel, it was decided to invest the £3.1m from 2015/16 in key areas of customer service. How the benefit in 2016/17 is to be applied will again be considered by the Watershare panel during 2017/18.

### *NON-HOUSEHOLD RETAIL MARKET*

Since 1 April 2017, up to 1.2 million businesses and other non-household customers across the country are now able to choose who they buy water and wastewater retail services from. Wholesale services, providing water to premises and taking wastewater away, are unaffected, but business customers can now choose who provides their retail service.

Following an extensive internal programme to ensure that South West Water was ready to comply with the requirements of the market and continue to deliver wholesale services to a high standard, South West Water's non-household retail business was transferred to a fellow group company, Pennon Water Services on 1 April 2017.

Pennon Water Services operates independently of South West Water and can secure services from any wholesaler in the United Kingdom. Equally, South West Water has the freedom to supply other business retailers around the UK who obtain a water supply licence.

From October 2016, South West Water fully engaged in a period of 'shadow operation' to ensure that systems and processes were ready for the opening of the market, operating as closely as possible to the market conditions and requirements, whilst ensuring customer service levels were maintained.

## **FUTURE MARKET OPPORTUNITIES**

Ofwat is promoting the development of a market for bio-resources (a product from sewage which can be used for energy or as a fertiliser substitute) and a market for water resources. We have conducted preliminary work on these potential opportunities during the year and are actively engaged with Ofwat in developing the potential frameworks for these markets.

Ahead of PR19 we are also engaging with customers and stakeholders around their priorities for water and wastewater services over the short and long-term. The initial findings have helped inform our updated 25-year strategic plan which is being published during the summer.

## **OUR COMMUNITY**

### *REGIONAL ECONOMY*

South West Water is one of the largest companies in its region. The services it provides are essential for the area's economic sustainability and the company supports the employment of around 5,000 staff directly and indirectly through the supply chain.

### *CHARITABLE PARTNERSHIPS*

In 2016/17 South West Water provided almost £75,000 of community sponsorship as part of its business plan. Using the Business in the Community framework as a guide, which marries core business purpose with identified community and social needs, South West Water's main sponsorships were with:

- Devon and Cornwall Wildlife Trusts – in support of their community engagement and educational outreach programmes. Activities included a 2-day Wildlife Celebration at Trebah Gardens in Cornwall and 55 school visits to Wembury Marine Centre in Devon
- Surf Life Saving GB – in support of the Nippers & Youth Championships and a three-year Graduate Lifeguard Project programme for young people who will be able to gain a National Vocational Qualification and become a Level 1 Coach at age 16.
- The South West Coast Path Association, which takes care of the 630-mile coast path, one of the region's main tourist attractions, overlooking our designated bathing waters
- British elite windsurfer and Olympic hopeful Izzy Hamilton, from Bude, who learned to windsurf at Roadford Lake.

### *ACCESS AND RECREATION*

The South West Lakes Trust, an independent charity, manages over 14,000 acres on South West Water's behalf. The Trust is the region's largest combined environmental and recreational charity, taking care of 50 inland water sites which attracted more than 1.9 million visits during 2016/17. South West Water is one of the largest companies in its region.

Conservation, access and recreation activities in the Bournemouth Water area, including management of fisheries and moorings, are now also being managed by South West Lakes Trust on South West Water's behalf.

## WORKPLACE

Our goal is to attract and retain talented people with the knowledge, skills, values and behaviours required to deliver the Company's long term goals and objectives. Underpinning this, and in line with human rights principles, we have a range of policies covering health, wellbeing and safety, equal opportunities, diversity, ethics and employee relations.

All elements of our workplace strategy apply to both our permanent and temporary workers and we expect suppliers and contractors to comply with relevant legislation and to hold similar principles.

### HEALTH AND SAFETY

South West Water strives for the highest standards of health and safety in the workplace to minimise accidents, incidents and lost time. It aims to ensure that all our people return home safe every day. The Company is working hard to ensure health and safety is embedded within the culture of the organisation, reduce risk and achieve zero incidents. Health and safety is the first item on the agenda for every Board meeting.

Performance in respect of RIDDOR (Reporting of Injuries, Diseases and Dangerous Occurrences Regulations 2013) reportable injuries has improved on a like-for-like basis in the original South West Water area, with six reportable injuries in the 2016 calendar year (2015: seven). Regrettably in the Bournemouth Water area, the number of reportable injuries increased from one in 2015 to three in 2016.

A new group-wide vision and strategy for health and safety, designed to raise standards, prevent harm and create a culture of safety across the business has also been announced for 2017/18.

Following a major review of its operational sites, South West Water has been undertaking a number of activities to further reduce health and safety risks, including at Bournemouth Water, as we look to ensure best practice at all of sites.

In pursuit of this ambition, South West Water is reviewing how it evaluates and controls health and safety risk, how it engages with its employees, how it builds greater leadership and accountability for health and safety, and how it strengthens its standards that deliver safe outcomes. Supporting this approach is the appointment of a new Pennon Director of Safety, Health, Environment, Quality and Sustainability, who is focused on implementing an enhanced health and safety strategy across the whole Pennon Group and will introduce concepts and learning from other industries reinforcing that health and safety is core to our way of working.

### 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 and training opportunities are in place to encourage career development. These range from operational upskilling programmes to management training. The Company continues to review and expand these to ensure it has the right balance of skills for the years ahead.

In 2016/17 South West Water's employee development programme included:

- continuing the programme of skills-based training for operational staff (started in 2014/15)
- specific training for all staff aligned to the requirements of the new non-household retail market and ensuring a level playing field
- continuing to grow and expand the Company's award-winning Apprenticeship programme (in excess of 100 apprentices have been recruited to the apprenticeship programme since it started in 2011).

Also during the year South West Water provided specialist training for our call handlers in a range of skills including a programme with the mental health charity MIND, designed to help call handlers recognise if a customer is struggling to pay their bills owing to stress or depression.

#### **APPRENTICESHIPS**

Apprenticeships provide a legacy for the skills and knowledge that are integral to the Company's core business. In 2016/17 South West Water recruited our 100<sup>th</sup> apprentice amongst 17 new apprentices, taking the current total to 102 across the business.

#### **EMPLOYEE ENGAGEMENT**

We believe motivated and engaged people value their own health and safety and that of their colleagues, drive greater productivity, and aspire to deliver higher levels of customer satisfaction.

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 2016/17 employee survey (including the Bournemouth Water area) showed a 79% response rate, with more than 1,100 employees completing the survey. The Engagement Index remained slightly lower than our benchmark of 70% at 68%, with areas of focus including more communication on Company changes and decisions and taking further action to address issues raised in the survey. South West Water is implementing action plans across the business to act upon the survey results.

#### **WORKPLACE DIVERSITY**

South West Water is an Equal Opportunities employer. We are committed to providing equal opportunities and improving diversity within its workforce. In the South West region, 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 23% of the workforce is female (up 2% from 2015/16), 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

## OVERVIEW

South West Water achieved a strong financial performance in 2016/17. We delivered against our strategic objectives to lead in the UK's water sector, invest for growth and drive value for efficiency.

South West Water's Return on Regulated Equity (RORE) has led the sector since the start of the current regulatory reporting period and is outperforming with a RORE of 12.6%.

South West Water continued its significant investment programme with the £60m water treatment works in Plymouth, the largest capital expenditure in our current five-year plan. South West Water's wholesale and non-household retail areas engaged fully in a period of 'shadow operation' ahead of the opening of the non-household retail market, which has resulted in a successful entry into the market.

We maintained our strong record of controlling total expenditure and remain at the forefront of cost efficiency in the water sector. Together these efficiency initiatives support the Board's pledge to reduce bills in real terms over the 2015-20 regulatory period.

South West Water's profit before tax and non-underlying items increased by £13.8m to £173.4m, reflecting the combined water business following the integration of Bournemouth Water, strong operational cost control and favourable interest charges. Statutory profit before taxation has increased from £154.4m to £172.9m

## BOURNEMOUTH WATER

On 1<sup>st</sup> April 2016, Bournemouth Water's operations and Ofwat licence was merged with South West Water. In addition, the activities of two non-regulated businesses; Aquacare and Avon Valley, were also transferred to the Company. As a result, a further £100.0m of authorised shares of £1 each were allotted and fully paid to Pennon Group plc bringing the Called Up Share Capital of the enlarged business to £250.9m against an authorised value of £500.0m. The financial results of South West Water now incorporate both regions and have therefore increased accordingly.

## REVENUE

Total revenue has increased by 11.1% to £562.5m. An additional £3.9m of revenue was generated by 7,900 new customer connections in the South West Water region and 1,150 in the Bournemouth Water regions.

81% of South West Water's customers are now benefitting from a metered supply, with 7,700 customers opting for a meter in 2016/17 (2015/16: 6,058). 69% of customers in the Bournemouth Water region are metered with 2,100 switching in the year (2015/16: 2,551).

## **OPERATING COSTS (BEFORE NON-UNDERLYING ITEMS)**

With the Retail Prices Index (RPI) rising by an average of 3.1% (31 March 2016 to 31 March 2017) and the growth within revenue, operating costs excluding depreciation, increased by £25.3m (13.4%) to £213.9m. Depreciation and amortisation rose by £11.0m due to the Bournemouth Water integration and accelerated capital expenditure during the current K6 period.

The key movements were:

- lower doubtful debt charges
- additional efficiencies delivered in the year

offset by:

- cost increases (including non-household market opening costs)
- cost of meeting higher customer demand (2.5% higher than 2015/16)

Driven by strong collections performance and working with customers to manage their debt, the bad debt charge as a percentage of revenue fell further to 1.1% (2015/16: 1.5%). Net debts totalling £4.5m (2015/16: £3.5m) were written off against the provision during 2016/17, of which £3.4m related to personal and commercial bankruptcy and £1.3m related to our ReStart programme, a South West Water customer affordability initiative. The overall higher value in this year reflected a detailed review of customers who had moved properties and where debt had been outstanding for a number of years. This review takes place every other year.

Operating costs also include a fine for £1.8 million issued in April 2017 relating to a HSE prosecution following the tragic fatality of an employee at a wastewater treatment works in December 2013.

## **NET FINANCE COSTS**

Net finance costs have increased from the prior year at £61.4m (2015/16: £55.4m), predominantly reflecting the higher interest on RPI index-linked debt and reprofiling of lease interest. £2.8m of interest was capitalised on longer term capital schemes reflecting the increase in longer term projects and value such as the Mayflower Water Treatment Works.

South West Water has access to overall interest rates that are amongst the lowest in the water industry with an effective rate of 3.2% in 2016/17. Interest cover for the year was both within the required levels for financial covenants and in line with expectations.

## **PROFIT BEFORE TAX**

The Company's underlying profit before tax was £173.4m, an increase of £13.8m from the prior year. On a statutory basis, profit before tax after non-underlying items increased by £18.5m to £172.9m.

## **TAXATION**

The current tax charge for 2016/17 of £31.6m (2015/16: £15.7m) includes £0.6m credit of adjustments for prior year, (2015/16: £10.5m).

A deferred tax credit of £8.9m (2015/16: £21.3m) resulted in a net total tax position of a charge of £22.7m (2015/16: credit £5.6m). The deferred tax 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.

The current overall tax charge in year increased £15.9m on 2015/16. This reflects the increase in profit reported, and adjustments to the tax charge in respect of prior periods.

During the year we have resolved with HMRC the treatment of certain uncertain tax items. Provisions for uncertain tax items had been recognised in previous years, no further amounts are required to be recognised in relation to these items.

#### **NON-UNDERLYING ITEMS**

Non-underlying items totalling a charge before tax of £0.5m have been recognised which represents a £0.5m charge for restructuring costs in the year.

#### **DIVIDENDS AND RETAINED EARNINGS**

The statutory net profit attributable to ordinary shareholders of £150.2m has been transferred to reserves.

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 £213.1m were paid to the parent undertaking (2015/16: £74.9m), representing a base dividend of £58.4m and £54.7m of outperformance dividend based on cumulative performance for 2015/16 and £100.0m taking into consideration the balance sheet position of key financial ratios.

The dividend was calculated with reference to the projections in the Ofwat 2014 Final Determination and the assumptions for 2016/17 included within the 2015-20 Business Plan.

#### **CAPITAL INVESTMENT**

Capital additions for the year were £190.9m, an increase from £126.3m in South West Water and £7.8m in Bournemouth Water 2015/16. 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
- acceleration of spend on the Tottiford Granular Activated Carbon (GAC) installation
- investments in sludge treatment assets ahead of innovative programmes aimed at further renewable energy generation
- expansion of the water and sewer networks through requisitions
- delivering additional capacity to meet growth requirements.
- investment in the Market Ready programme

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

## CASH FLOW

Operational cash inflows in 2016/17 at £330.7m were £32.2m higher than last year (2015/16: £298.5m). These funds have been put to use in effectively financing the Company's capital structure and investing in future performance and growth, through our substantial capital investment programme. This investment has resulted in higher net debt.

## LIQUIDITY AND DEBT PROFILE

The Company has a strong liquidity and funding position with £247.4m cash and deposits at 31 March 2017 (including £221.7m of restricted funds representing deposits with lessors against lease obligations). In addition the Company has £510.0m of undrawn facilities.

The Company's financing structure gives the 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 2017 the Company's loans and finance lease obligations totalled £2,281.2m. After the £247.4m held in cash this gives a net debt figure of £2,033.8m (an increase of £240.5m during the year).

The Company's debt has a maturity of up to 40 years with a weighted average maturity of 24.5 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 £492.7m of debt index-linked to 2033-2057 at an overall real rate of 1.89%. 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 2016/17 of 3.2%.

At 31 March 2017 the fair value of the Company's non-current borrowings was £2,177.4m (2016: £1,791.2m) which is more than its book value (2016: less than its book value) as detailed in note 22 to the financial statements. This reflects the benefit of securing interest rates below the current market rate.

## CAPITAL STRUCTURE

Net debt increased by £240.5m during the year, reaching a total of £2,033.8m. The increase primarily reflects the merger of Bournemouth Water and South West Water and 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 2017 RCV equalled £3,290.6m, an increase of £140.4m (4.5%) in the year driven by the merger of Bournemouth Water, planned capital investment and RPI at the year end. The RCV at 31 March 2016 was £2,997.3m for South West Water and £152.9m for Bournemouth Water (prior to merger).

South West Water's net debt to RCV has increased by 2.0% to 61.8%, which is aligned 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.

## INTERNAL BORROWING

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 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 £31.6m (2015/16: £15.7m). A reconciliation between the actual tax charge, current tax and deferred tax, and the estimated charge at 20% of profit before taxation is provided in Note 8 to the financial statements.

The Company made a net payment of £31.6m of UK corporation tax in the year (2015/16: £32.4m).

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 £44.3m 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 £26.4m after refunds of £0.4m paid to local authorities. This is a direct cost and reduces profit before tax
- Employment taxes of £13.7m including employees' Pay As You Earn (PAYE) and total National Insurance Contributions (NICs)
- Carbon Reduction Commitment (CRC) payment for the Company was £2.1m representing the commitment payments for carbon usage in 2016/17. This reduces profit before tax

- Climate Change Levy of £1.5m related to energy cost was paid in the year. This also reduces profit before tax
- Fuel Excise Duty of £0.7m related to transport costs. This reduces profit before tax.

The corporation tax rate for 2016/17 used to calculate the current year's tax is 20% (2015/16: 20%).

## **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 2017 the Company's share of the pension schemes showed an aggregate deficit (before deferred tax) of £32.3m (2015/16 / £29.6m), whilst the deficit has increased due to post-Brexit fall in bond yields increasing the value of liabilities, over half of the increase in the valuation of liabilities have been offset by increases in asset values.

The Company did not make a deficit recovery payment into the scheme in 2016/17 (2015/16: £18.3m). South West Water's regular cash contributions to the schemes remain within Ofwat's Final Determination for the K6 period.

The 31 March 2016 actuarial valuation of the Pennon Group Scheme has been finalised and is in line with expectation and the 2013 valuation and contributions remained in line with Final Determination (FD) allowances.

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

# 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 operates 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 in line with the Company's risk appetite 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 over a five-year period, and impact based on financial, reputational, management effort and impact on stakeholders and customers
- 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, which provides a 'top down' assessment of the group's risks. 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 Board and Audit Committee following a robust risk assessment. The executive management perform 'bottom up' risk assessments.

## 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.

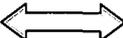
## ROBUST RISK ASSESSMENT

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 29 to 30.

Key	Risk level		
	Low	Medium	High
The low, medium and high risk level is our estimate of the net risk to the Company after mitigation. It is important to note that risk is difficult to estimate with accuracy and therefore the actual risk may be greater or less than our estimate indicated.			
	GREEN	AMBER	RED
Current assessment of direction of travel of risk level	Increasing 	Stable 	Decreasing 

## LAW REGULATION AND FINANCE

Compliance with laws and regulation or decisions by Government and regulators, including water industry reform		GREEN 
<p><b>Commentary</b> 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>Non-compliance could lead to financial penalties and additional costs which could undermine our efforts to maximise cost base efficiency. Damage to reputation could affect shareholder value.</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>The June 2017 General Election could lead to a changed regulatory environment.</p> <p><b>Risk Appetite</b> 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> <p>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>	<p><b>Mitigation</b> 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. South West Water has strong Board leadership and governance supported by an integrated risk and assurance framework, which is fully embedded.</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>A robust internal regulatory framework ensures compliance with Ofwat, Environment Agency and other requirements. Full engagement in consultations on reform of policy and legislation, helps influence change through effective stakeholder relationships.</p> <p>Clear and accessible guidance for employees is in place, training has been rolled out and is ongoing.</p> <p>Good progress has been made in preparing for future regulatory reform. We are fully engaged in the Water 2020 programme including upstream regulatory reform. External reviews support the assurance letters required by the Market Operator.</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>	

<b>Non-compliance with health and safety legislation or occurrence of avoidable health and safety incident</b>		<b>AMBER</b> 
<p><b>Commentary</b> 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 the 2016 calendar year was six in the South West area (2015: seven). In the Bournemouth area the number of incidents rose to three (2015: one).</p> <p>Higher standards are expected both internally and externally, and therefore the underlying risk of not achieving these higher standards is considered to be rising.</p> <p><b>Risk Appetite</b> High standards of compliance are sought with no appetite for compliance breaches within South West Water and third party operations.</p>	<p><b>Mitigation</b> Rigorous health and safety compliance systems, policies and procedures are in place across the Group, supported by a programme of capital investment to mitigate health and safety risks.</p> <p>Risks identified in detailed site risk assessments have continued to be addressed.</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>	

<b>Maintaining sufficient finance and funding to meet ongoing commitments</b>		<b>GREEN</b> 
<p><b>Commentary</b> South West Water requires long term borrowing in order to fund the Company's capital programme.</p> <p>Failure to maintain funding could lead to additional finance costs and put strategic priorities at risk.</p> <p>The Company currently has a strong liquidity and funding position.</p> <p><i>The Company can be impacted by wider economic conditions and availability of finance from banks and other institutions.</i></p> <p><b>Risk Appetite</b> Ensuring that funding requirements are fully met by maintaining prudent headroom.</p>	<p><b>Mitigation</b> 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 are 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 pre-funding and headroom, including revolving credit facilities, to meet future funding requirements.</p>	

<b>Increase in defined benefit pension scheme deficit</b>		<b>GREEN</b> 
<p><b>Commentary</b> The Company could be called upon to increase funding to reduce the deficit, impacting our cost base.</p> <p>The risk increased post the UK's vote to leave the EU due to market uncertainties. The situation has since stabilised, as evidenced by the outcome of the recent triennial evaluation, which demonstrates the recovery plan from 2013 is still on track.</p> <p><b>Risk Appetite</b> Ensuring that funding requirements are fully met by maintaining prudent headroom.</p>	<p><b>Mitigation</b> The group uses professional advisers to manage the pension scheme's investment strategy to ensure the scheme can pay its obligations as they fall due.</p>	

**MARKET AND ECONOMIC CONDITIONS**

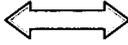
<b>Non-recovery of customer debt and affordability</b>		<b>AMBER</b> 
<p><b>Commentary</b> Customer debt and affordability are key areas of focus given the continued challenging economic conditions, such as inflation being in excess of average wage increases. It has been identified that within South 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><b>Risk Appetite</b> To minimise non-recoverable debt but recognising customer affordability challenges and that domestic customers cannot be disconnected the risk of uncollectable debt remains.</p>	<p><b>Mitigation</b> South West Water strategies are kept under review with new initiatives regularly implemented including:</p> <ul style="list-style-type: none"> <li>• targeting previous occupier debt after customer moves</li> <li>• specific case management and use of court claims</li> <li>• use of charging orders to secure debt after customer moves</li> <li>• engaging collection agencies to perform doorstep visits to customers with debts over one year old to arrange payment plans.</li> </ul> <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>	

**OPERATING PERFORMANCE**

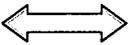
<b>Poor operating performance due to extreme weather or climate change</b>		<b>GREEN</b> 
<p><b>Commentary</b> South West Water continues to experience extreme weather – which has in general seen more periods of consistently dry weather but offset with short bursts of extreme rain and some locally intense rainfall resulted in an increase level of storm flows into some wastewater treatment works and resultant discharges.</p> <p>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.</p> <p>South West Water has not experienced water restrictions for 20 years (and water restrictions have never been required in the Bournemouth area).</p> <p>While no new restrictions are envisaged, the risk is rising due to the recent dry weather.</p> <p><b>Risk Appetite</b> 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.</p>	<p><b>Mitigation</b> 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.</p> <p>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.</p> <p>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.</p>	

<b>Poor service being provided to customers</b>		<b>AMBER</b> 
<p><b>Commentary</b> Customer service remains paramount to South West Water and the Company focuses on improving customer satisfaction and reducing customer complaints.</p> <p>Following extensive customer and other stakeholder consultation, performance commitments were developed against key customer priorities.</p> <p>South West Water aims to prevent issues and problems arising, avoiding the need for customers to contact us.</p> <p>However, when a customer does need to contact us our aim is to resolve all contacts as quickly and professionally as possible, providing great customer service and ensuring our customers are not unnecessarily inconvenienced.</p> <p>South West Water has met the majority of its commitments for 2016/17 and continued year on year improvements have been achieved in most areas.</p> <p>Certain of the commitments remain challenging and South West Water also aims to improve its position relative to the industry, which currently is towards the lower end of performance.</p> <p><b>Risk Appetite</b> Good customer service is at the heart of South West Water with the aim of increasing customer service and customer satisfaction.</p>	<p><b>Mitigation</b> During the year targeted improvements have been made in order to increase the Company's customer service performance. Specific measures taken include:</p> <ul style="list-style-type: none"> <li>• improvements to visible leak repair processes</li> <li>• focus on increasing the speed of attendance at external flooding incidents by our external contractors</li> <li>• direct consultation with customers who had experienced our leakage process and implementation of improvements based upon their feedback</li> <li>• website improvements and internal training in respect of wastewater flooding</li> <li>• an increase in the number of meter reads we perform to reduce the degree of estimation in customers' bills</li> </ul> <p>South West Water continues to track customer satisfaction throughout the year in order to understand changes in perceptions with different attributes of our service.</p> <p>Further improvements will be implemented based upon this ongoing satisfaction tracking, including a relaunch of the South West Water website in 2017/18.</p>	

<b>Significant operational failure or incident occurring</b>		<b>AMBER</b> 
<p><b>Commentary</b> 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"> <li>• water quality deterioration</li> <li>• contamination of water supplies</li> <li>• pollution and flooding events</li> <li>• water resource restrictions.</li> </ul> <p>During 2016/17 South West Water experienced one Category 1 pollution incident and three Category 2 pollution incidents. External levels of expectation and penalties for pollution incidents are increasing.</p> <p>Further work is required to achieve South West Water's target of no Category 1 or 2 pollution incidents.</p> <p><b>Risk Appetite</b> 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>	<p><b>Mitigation</b> South West Water has established and detailed procedures, contingency plans and incident management procedures.</p> <p>Equipment failure is managed through sophisticated planned preventative maintenance regimes. Any disruption is alleviated by good liaison and communication.</p>	

<b>Difficulty in recruitment, retention and development of appropriate skills, which are required to deliver the Company's strategy</b>		<b>AMBER</b> 
<p><b>Commentary</b> 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, finance and scientific areas).</p> <p><b>Risk Appetite</b> To ensure staff have appropriate skills and experience with good succession plans to mitigate the impact on our strategic priorities and plans.</p>	<p><b>Mitigation</b> South West Water has established a range of development programmes including:</p> <ul style="list-style-type: none"> <li>• Lead 2020 – senior management programme</li> <li>• Managing for Success (M4S) – for first line managers</li> <li>• STEP – for managers and other staff</li> <li>• apprentice programme</li> </ul>	

## BUSINESS SYSTEMS AND CAPITAL INVESTMENT

<b>Information technology systems, management and protection including cyber risks</b>		<b>AMBER</b> 
<p><b>Commentary</b> Recent security breaches across a range of industries highlights the growing risk of a sophisticated cyber-attack.</p> <p><b>Risk Appetite</b> To ensure robust systems and security in place to support business activity with strong cyber protection to minimise a growing risk.</p>	<p><b>Mitigation</b> Major systems implementations are supported by a formal programme governance framework, supplemented by specialist consultants.</p> <p>Cyber risks are mitigated by a strong information security framework, cyber security awareness campaigns, plus internal and external testing (including penetration testing) and formal ISO 27001 accreditation.</p> <p>We ensure that all possible measures are in place in line with guidance issued by the National Cyber Security Centre (NCSC), commensurate with the fast changing cyber risk landscape.</p>	

<b>Failure or increased cost of capital projects/exposure to contract failures</b>		<b>GREEN</b> 
<p><b>Commentary</b> South West Water continues to invest in capital projects to protect and enhance its water and wastewater processes and networks.</p> <p>During the year, it commenced construction of the Mayflower Water Treatment Works in North Plymouth. The site will use new technology to provide high quality drinking water to customers in Plymouth in as efficient manner as possible.</p> <p>The project is a major investment for South West Water and forms part of the capital programme in the 2015-20 business plan.</p> <p><b>Risk Appetite</b> South West Water's investment activities are based on taking well-judged risks for appropriate returns (both in terms of quality improvements and cost efficiencies in process).</p>	<p><b>Mitigation</b> Skilled project management resource and oversight boards provide rigour to the delivery of major projects.</p> <p>Thorough due diligence is performed on suppliers, technologies and acquisitions. Back-to-back agreements and supplier guarantees provide protection in many circumstances.</p> <p>Performance on major contracts is reported internally on a regular basis and post project appraisals are performed.</p>	

## THE UNITED KINGDOM'S EXIT FROM THE EUROPEAN UNION

As with all major decisions and changes that affect our business, South West Water conducted a thorough analysis of the possible implications of a vote to leave the European Union. South West Water did not take a public stance on the referendum in June 2016 as the Board believed the vote was a personal decision.

It is too early to know the implications of the vote to leave; this will only become clear when negotiations following the March 2017 triggering of Article 50 of the Lisbon Treaty are complete. In the meantime we are tracking the implications of leaving in assessing every risk.

### 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 23 to 28 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.

Over the course of the year the Audit Committee has considered a deep-dive review of the following principal risks to enable a thorough assessment of the impact of these risks on ongoing viability:

Principal risk	Matters considered by the Audit Committee
Cyber security	Review of the cyber security framework in place
Financial markets	Ability to manage external shocks or potential market disclosures that could impact on financing strategy
'Brexit'	Initial assessments of the implications and mitigations
Wholesale energy	Review of energy risk strategy to mitigate volatility in the wholesale energy market
Drinking water contamination	Review the risk of drinking water quality in the event of significant water contamination
Legislative and regulatory compliance	Management of changes in EU and UK legislation and regulation, including the impact of 'Brexit'
Debt collection	Non-recover of household debt risks and mitigations
Recruitment and retention	Review of people risks including the ability to attract and retain the right skills to deliver strategy
Water resources and resilience	Consider the impact of climate change and drought risks on water resources and ongoing resilience

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.

The five-year period was chosen for consistency with the length of the business's regulatory contract and the associated business planning cycle, and the longer-term nature of the company.

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 46 to 52, the Directors reviewed and discussed the process undertaken by management, and also reviewed the results of the stress testing performed.

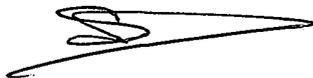
#### **FORWARD-LOOKING STATEMENTS**

This strategic report, consisting of pages 3 to 22, 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.

The strategic report consisting of pages 3 to 22 was approved by the Board on 30 May 2017.

By Order of the Board



S Bird  
Managing Director  
30 May 2017

# GOVERNANCE AND REMUNERATION

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## INTRODUCTION

Strong governance is central to the successful management of any company. It provides the framework for effective delivery of our strategy and the ongoing development of our sustainable business and South West Water remains committed to ensuring that we continue to operate to the highest standards of corporate governance.

At the beginning of the year the structures across Pennon Group were reviewed and a revised governance structure implemented from April 2016. This has reinforced the good governance already in place and has helped ensure we operate effectively and cohesively across the Group with efficient and transparent decision-making while preserving the degree of regulatory independence that Ofwat requires for the ring-fenced business of South West Water.

During the year the operation of this structure was monitored and a review was carried out by Pennon's Senior Independent Director and South West Water Non-executive Director, Gill Rider, alongside an independent external evaluation of the Board's structure, operation and performance. Based on these assessments, the Board has concluded that the governance framework, which comprises the operation of the Board, its Committees and executive management, as well as the risk management and internal control environment described on pages 23, 43 and 44, is robust and effective, and is operating smoothly.

We describe the governance structures, Board and committee membership as well as the governance within executive management on pages 32 to 63.

## SOUTH WEST WATER LIMITED BOARD OF DIRECTORS

The South West Water Board of Directors at the end of the 2016/17 financial year comprised the Chairman (a Non-executive Director), three Executive Directors, and five further Non-executive Directors. In addition Susan Davy, Pennon Group Chief Financial Officer also attends the South West Water Board. 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.

<b>Sir John Parker</b> Chairman
<b>Appointment</b> Sir John was appointed to the South West Water Board on 31 July 2015 having been appointed to the Pennon Group Plc Board as Deputy Chairman on 1 April 2015.
He became Chairman of both boards on 1 August 2015. He is also chairman of the Nomination Committee.
<b>Skills and experience</b> Sir John is a highly experienced and independent chairman and brings a wealth of leadership experience across a range of industries. He won the lifetime achievement award at The Sunday Times 2015 Non-Executive Director Awards and is widely recognised for his policy work on corporate governance, including the value of diversity in the boardroom.
He has chaired five FTSE100 companies and 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. He was also president of the Royal Academy of Engineering from 2011 to 2014.
<b>External appointments</b> Sir John is the chairman of Anglo American Plc and Advanced Plasma Power Limited. He is also a non-executive director of Carnival Corporation, Airbus Group and is a Visiting Fellow of the University of Oxford.
Sir John's outside commitments are expected to reduce in 2017, when he retires from the board of Anglo American plc.

<b>Chris Loughlin</b> Pennon Group Chief Executive Officer
<b>Appointment</b> Chris was appointed to the Board on 1 August 2006 as Chief Executive of South West Water. He became the Pennon Group Chief Executive Officer on 1 January 2016.
Chris is a member of the Sustainability Committee.
<b>Skills and experience</b> Chris has extensive experience of the regulated business environment and the management of major engineering and infrastructure services. He started his career as a chartered engineer working in both the consulting and contracting sectors and, after holding a number of senior positions with British Nuclear Fuels plc, joined its board as an executive director. Prior to joining Pennon he was chief operating officer with Lloyds Register and before that executive chairman of Magnox Electric plc. He was also a senior diplomat in the British Embassy, Tokyo.
Chris has a comprehensive understanding of the water industry. He was previously a board member (and, for a period, president) of the Institute of Water, and between April 2008 and March 2012 was chairman of Water UK.
<b>External appointments</b> Chris is currently chairman of British Water, a director of Water UK and a trustee of the charity WaterAid. An enthusiastic advocate of local business, Chris is also vice chairman of the Cornwall Local Enterprise Partnership.

<b>Dr Stephen Bird</b> Managing Director
<b>Appointment</b> Stephen was appointed to the Board on 1 March 2000 and was appointed to the position of Managing Director of South West Water on 1 January 2016.
<b>Skills and experience</b> 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.  He is a Fellow of the Chartered Institute of Environmental Managers, fellow of the Institute of Directors and holds an MBA.
<b>External appointments</b> Stephen is Director of the Heart of the South West Local Enterprise Partnership and a member of Water UK Council.

<b>Louise Rowe</b> Finance Director
<b>Appointment</b> Louise was appointed South West Water Finance Director on 1 February 2015
<b>Skills and experience</b> Louise has been with South West Water for over eight years, holding a range of managerial roles in the Finance Directorate prior to her appointment as Finance Director.  She is physics graduate and qualified as a chartered accountant with KPMG.
<b>External appointments</b> Louise is a member of the Water UK Finance Directors Forum and the Prince of Wales' Accounting for Sustainability's Finance Culture Project. She was recently appointed Non-executive Director for the Cornwall and Isles of Scilly Local Enterprise Partnership.

<b>Martin Angle</b> Non-executive Director
<b>Appointment</b> Martin was appointed to the Board on 1 April 2016, having been appointed to the Pennon Group Plc board on 1 December 2008. He is chairman of the Remuneration Committee and a member of the Audit, Nomination and Sustainability Committees.
<b>Skills and experience</b> Martin is an experienced non-executive director, bringing a wide range of knowledge and experience from a career in investment banking, private equity and industry.  Over a 20-year executive career in investment banking, Martin held senior roles with SG Warburg & Co. Ltd, Morgan Stanley and Dresdner Kleinwort Benson, before becoming the group finance director of TI Group plc, then a FTSE 100 company. He subsequently joined Terra Firma Capital Partners where he held various senior roles in its portfolio companies, including the executive chairmanship of the Waste Recycling Group Limited, then a major participant in the UK waste sector, and Le Meridien Hotel Group where he was executive deputy chairman.  Martin has also served as a non-executive director on a number of boards including Savills plc, where he was the senior independent director; National Exhibition Group, where he was chairman; Severstal; and Dubai International Capital.  As chairman of the Remuneration Committee, Martin has steered the approach on executive remuneration, ensuring that it is aligned with and supports strategy.
<b>External appointments</b> Martin is currently vice chairman and non-executive director of the FIA Foundation, the adviser to the Board of the Commercial Bank of Dubai and the adviser to NGP, a private group based in the USA, which is building out a major platform in renewable energy in emerging markets.

**Neil Cooper** Non-executive Director

**Appointment** Neil was appointed to the Board on 1 April 2016, having joined the Pennon Group Plc Board on 1 September 2014. He is chairman of the Audit Committee and a member of the Remuneration and Nomination Committees.

**Skills and experience** Neil brings to the Board extensive experience in a wide variety of corporate and financial matters. Most recently, he was group finance director of Barratt Developments plc and, before that, group finance director of William Hill plc and Bovis Homes plc.

He also held senior finance positions at Whitbread plc, worked for PricewaterhouseCoopers as a management consultant and held a number of roles with Reckitt & Colman plc.

As chairman of the Audit Committee, Neil has been influential in directing the approach on a number of significant matters including internal control, governance and financial reporting.

**External appointments** None.

**Martin Hagen** Non-executive Director

**Appointment** Martin was appointed to the Board on 1 September 2010

**Skills and experience** Martin 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.

**External appointments** Martin is an independent member of the Audit and Risk Assurance Committee of the Department for Work and Pensions (DWP), Governor and Audit Committee Chair of UWE Bristol and a Board member and Audit Committee. He is also Chair of Companies House.

**Gill Rider** Non-executive Director

**Appointment** Gill was appointed to the Board on 1 April 2016, having been appointed to the Pennon Group Plc board on 1 September 2012. She is chairman of the Sustainability Committee and a member of the Audit, Remuneration and Nomination Committees.

**Skills and experience** Gill has a wealth of experience in leadership, governance and remuneration across a broad range of sectors including professional services, education and government.

Formerly, she 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 and Development and a non-executive director of De La Rue plc.

As chairman of the Sustainability Committee, Gill has encouraged and supported executive management in the development of a sustainability programme that underpins the delivery of strategy. At Accenture she chaired the global corporate responsibility and Foundation giving programme and was instrumental in building sustainability objectives into Accenture's worldwide human capital strategies.

**External appointments** Gill currently holds non-executive directorships with Charles Taylor plc, where she is senior independent director, and Intertek Group plc. She is chairman of both their remuneration committees. She is also chair of the council (board) of the University of Southampton.

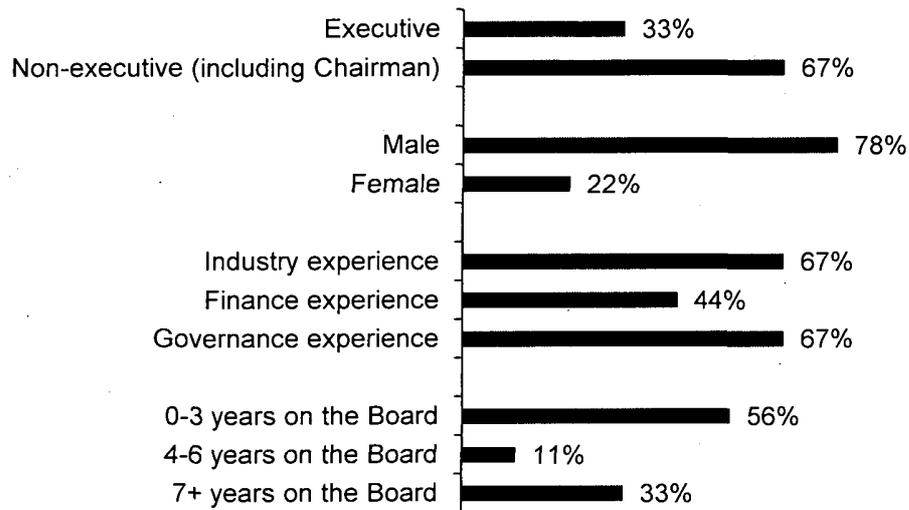
**Lord Matthew Taylor** Non-executive Director

**Appointment** Matthew was appointed to the South West Water Board on 1 March 2010

**Skills and experience** Matthew was MP for Truro and St Austell for 23 years from 1987, until he stood down at the 2010 general election. He has expertise in planning for sustainable communities.

**External appointments** Lord Taylor of Goss Moor Chairs the St Austell Eco-Community Strategic Partnership Board. 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.

**BOARD COMPOSITION, DIVERSITY, EXPERIENCE AND TENURE (AS AT 31 MARCH 2017)**



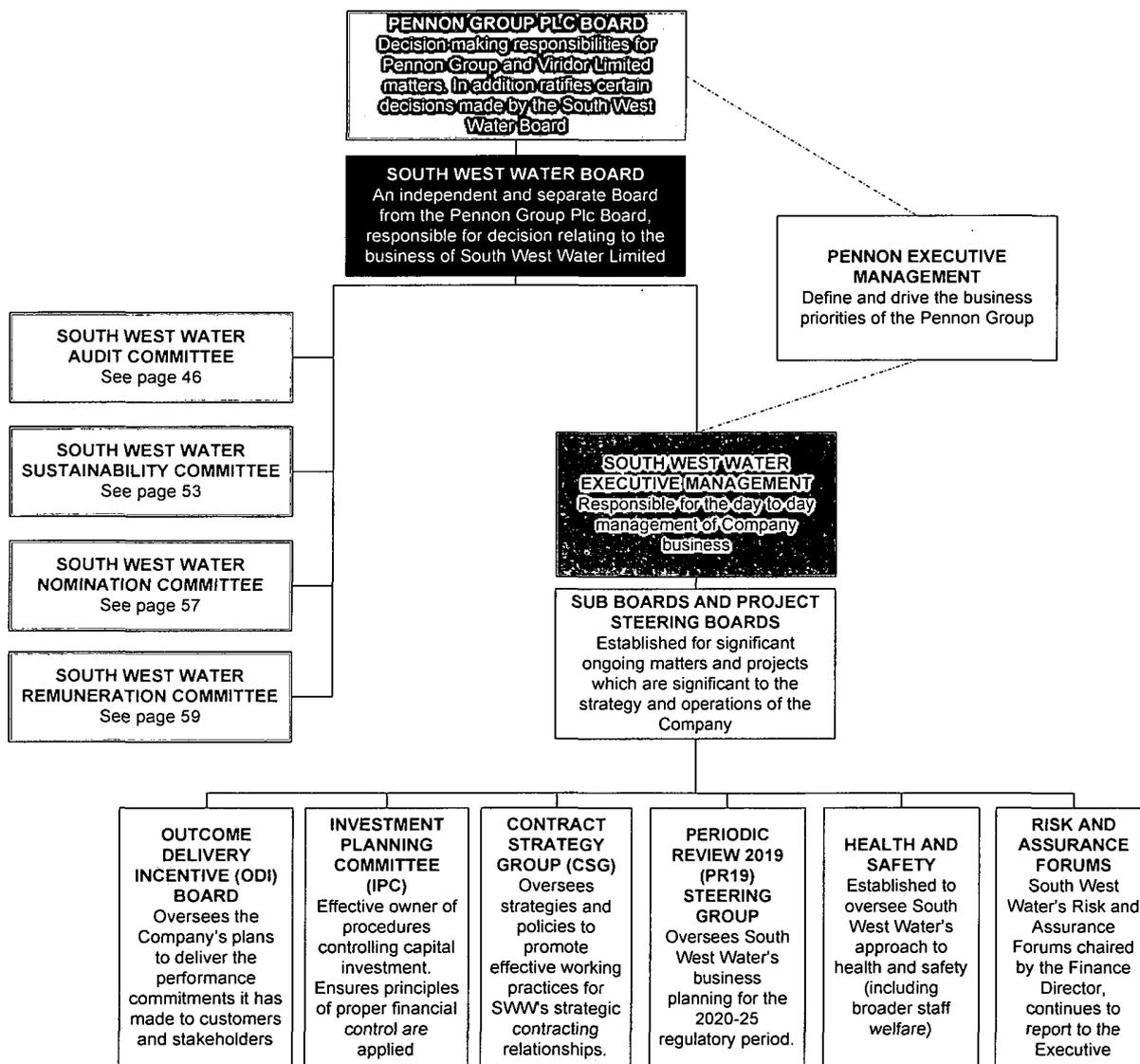
Notwithstanding their directorship of Pennon Group plc, Martin Angle, Neil Cooper and Gill Rider are considered to be independent in character and judgement given that they were appointed to the South West Water Board in order to facilitate the Group's revised governance framework, rather than to represent the interests of the shareholder.

# THE BOARD AND ITS GOVERNANCE FRAMEWORK

## GOVERNANCE STRUCTURE

### BOARD STRUCTURE SUMMARY

The following diagram summarises the context and structure which the South West Water Board operates within aligned with the revised governance approach of Pennon Group Plc:



### ***PENNON GROUP PLC BOARD***

The Pennon Group Board's responsibilities include overall leadership of the Pennon Group, setting the Group's values, policies and standards, approving Pennon's strategy and objectives and providing oversight of the Group's operations and its performance. The Pennon Group board has also reserved to itself the requirement to ratify certain decisions taken by the South West Water Board, including:

- major capital projects and investments
- long-term objectives and commercial strategy
- the five-year regulatory business plan
- annual budgets
- certain decisions relating to financing.

This approach is compatible with Ofwat's principles for holding companies in respect of Board leadership, transparency and governance.

### ***SOUTH WEST WATER BOARD***

As a regulated water and sewerage company which is part of the listed Pennon Group, it is important that South West Water acts as a separate company and that the interests of customers and other stakeholders are protected. South West Water's 'Board, Leadership, Transparency and Governance Code' commits it to acting as if it is a separate Public Listed Company as far as is possible.

The South West Water Board continues to operate as a separate independent board in accordance with its own schedule of matters reserved to ensure compliance with Ofwat's principles on board leadership, transparency and governance. As described in more detail on pages 41 to 42, South West Water itself complies with the UK Corporate Governance Code as far as is possible within the context of the group structure.

The Pennon Board and South West Water Board usually meet sequentially on the same day to allow a more holistic and cohesive approach to decision-making. This is in part facilitated by the dual directorships held by a number of directors and through the attendance of the Pennon Group Chief Financial Officer. This is mirrored by the Board Committees. Further information on the operations of the Board and committees are included on pages 32 to 63.

### ***PENNON EXECUTIVE MANAGEMENT***

The role of the Pennon Executive is to define and drive the Pennon Group's priorities that will achieve delivery of the Group strategy. It is responsible for ensuring, to the extent of the authority delegated by the Boards, the proper and prudent management of Group resources to create and maximise shareholder value.

Chaired by the Pennon Chief Executive Officer, the Pennon Executive meets formally on a monthly basis to review and refine recommendations to be presented to the both the Pennon and where applicable the South West Water Boards. Members of the Pennon Executive are:

- Chris Loughlin, Chief Executive Officer
- Susan Davy, Chief Financial Officer
- Helen Barrett-Hague, Pennon Group General Counsel & Company Secretary
- Adele Barker, Interim Group Director of Human Resources
- Stephen Bird, Managing Director, South West Water
- Sarah Heald, Director of Corporate Affairs & Investor Relations
- Steve Holmes, Director of Safety, Health, Quality & Sustainability(SHQS)
- Ed Mitchell, Director of Environment
- Phil Piddington, Managing Director, Viridor
- Paul Ringham, Commercial Director, Viridor
- Bob Taylor, Operations Director (Drinking Water Services) South West Water

### ***THE SOUTH WEST WATER EXECUTIVE MANAGEMENT***

Day to day management of South West Water's operations and activities is undertaken by South West Water's Executive Management. It includes Dr Stephen Bird (Managing Director) and Louise Rowe (Finance Director), who are also members of South West Water's Board and whose experience is described on page 34. There are four further members of the Executive Management, who have responsibilities for key areas of operations of South West Water:

- Jo Ecroyd – Customer Services Director
- Graham Murphy – Engineering Director
- Bob Taylor – Operations Director (Drinking Water Services)
- Iain Vosper – Regulatory Director

Towards the end of the year, Andrew Willicott, the Operations Director (Waste Water Services) resigned and the recruitment process for his permanent successor is ongoing, with Ed Mitchell acting as Interim Operations Director (Wastewater Services)

In addition following changes in the Pennon Group structure, Monica Read, Business Services and Sustainability Director, withdrew from South West Water's Executive Management to focus on the implementation of Pennon Water Services Limited.

Further information on the structure and operations of the South West Water Executive Management Team and the sub-committees which support the decision making of the business is included on pages 61 to 63.

# SOUTH WEST WATER BOARD

## BOARD MEMBERSHIP AND ATTENDANCE

The Directors and their attendance at the nine scheduled meetings of the Board during 2016/17 are as follows:

Board membership		Attendance <sup>(1)</sup>
<b>Chairman</b>		
Sir John Parker	Chairman	9/9
<b>Executive Directors</b>		
Chris Loughlin	Pennon Group Chief Executive Officer	9/9
Dr Stephen Bird	Managing Director	9/9
Louise Rowe	Finance Director	9/9
<b>Non-executive Directors</b>		
Martin Angle	Non-Executive Director	9/9
Neil Cooper	Non-Executive Director	9/9
Martin Hagen	Non-Executive Director	9/9
Gill Rider	Non-Executive Director	9/9
Lord Matthew Taylor	Non-Executive Director	9/9
Stephen Johnson <sup>(2)</sup>	Non-Executive Director	1/1
<b>In attendance</b>		
Susan Davy	Pennon Group Financial Officer	9/9

<sup>(1)</sup> Attendance includes only meetings during the appointment of the Directors

<sup>(2)</sup> Resigned 28 April 2016, recruitment currently ongoing for a replacement

In 2016 the number of scheduled Board meetings was reduced from ten to nine per year (plus an annual strategy day) and the number of scheduled Committee meetings was reduced to four per year to coincide with Board meetings. Board and Committee meetings are arranged over a session lasting a day and a half, which includes a working dinner for the Directors. Additional meetings of Committees are arranged as and when necessary. This approach allows for longer agendas and in depth review and discussion around complex matters.

## OPERATION OF THE BOARD

The Pennon Board and the South West Water Board meet sequentially, decisions relating to South West Water are discussed either through individual written reports or where appropriate through separate sections within Group reports or presentations. These are 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 discussions and decisions relating to South West Water are clearly noted within separate Board minutes.

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.

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.

#### **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.

The Board undertakes a formal and rigorous review of its performance and that of its Committees and Directors each year. This year, Armstrong Bonham Carter LLP, who are independent board performance consultants with no other connection with the Company, facilitated the evaluation of the Pennon Board's and the Committees' performance (incorporating South West Water). The exercise was conducted by way of a series of structured interviews with Directors, various members of the Pennon Executive Management, the Internal Audit Manager and the External Audit Partner.

The agenda for these interviews was circulated to each participant prior to the meetings and was designed to assess:

- whether the Directors had thoroughly discussed and agreed the use of shareholders' funds to ensure the Company was successful whilst managing the risks inherent in the strategy, plans and the operating environment
- the effectiveness of the Board in ensuring that the executive team had implemented the strategy and plans, and had managed all the other activities of the Company well. Armstrong Bonham Carter collated and analysed the results from each interview and prepared separate reports on the performance of the Board as a whole and one for each Committee, all of which were reviewed and discussed by the Board.

The review concluded that the Pennon Board and its Committees had demonstrated a high degree of effectiveness. The new Board structure was viewed most positively and had helped the Non-Executive Directors to achieve a broader knowledge of the Group. Consequently, the Board had a good understanding of opportunities for growth and the threats facing the business. The Pennon Board's commitment to health and safety was widely noted by participants and the appointment of a new Group director of Safety, Health, Quality and Sustainability (SHQS), who will work to embed a strong health and safety culture throughout the Group, was welcomed. In addition, the Board agreed to adopt actions relating to the development of Group strategy, the shaping of Pennon's corporate values and increased focus on employee engagement. Subsequently the Board agreed to implement an enhanced action plan which it will monitor regularly.

## **BOARD COMMITTEES' TERMS OF REFERENCE**

In accordance with Company policies, a range of key matters are delegated to the Board's Committees as set out on pages 46 to 60 of this governance report.

The terms of reference of each of the Board's Committees are set out on the South West Water website [www.southwestwater.co.uk](http://www.southwestwater.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 Group General Counsel & 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.

Newly appointed Directors receive a formal induction which includes an explanation of the Group structure, regulatory and legal issues, the governance framework and policies, the approach to risk management and the Company's principal risks (financial and non-financial, including environmental, social and governance (ESG) risks), duties and obligations (including protocols around conflicts of interest and dealing in shares) and the current activities of the Board and its Committees. Directors also visit operating facilities and have meetings with staff to receive briefings on key processes and systems.

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

## **DEALING WITH DIRECTORS' CONFLICTS OF INTEREST**

In accordance with the directors' interest provision of the Companies Act 2006 and the Company's Articles of Association, the Board has in place a procedure for the consideration and authorisation of Directors' conflicts or possible conflicts with the Company's interests. This operated effectively during the year.

## **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 2016/17 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 2016/17 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 Officer is a Director of the South West Water. 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 Company has complied fully with the provisions 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. Pennon Group Plc is South West Water's sole shareholder and therefore any shareholder concerns can therefore be communicated to the South West Water Board via the Group Chairman. Pennon Group Plc has itself appointed a Senior Independent Director.

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

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 (who is also a Director of South West Water). Code provision B.6.3. states that the Non-executive 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 Non-executive 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.

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, which carries out its assessment in conjunction with the South West Water 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, who is also a member of the Pennon Group Plc Board is 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

Consistent with the Group governance approach the Audit Committee for Pennon Group and South West Water meet sequentially on the same day. The items and decisions relating to South West Water are discussed either through individual written reports or where appropriate through separate sections within combined Group reports or presentations.

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.

The principal responsibilities of the Committee continue to be focused in a number of key areas: firstly on ensuring the appropriateness of the Company's financial reporting; an activity which includes the testing of accounting judgements made in preparing reporting and in assessing whether the presentation of the Company's activities is fair, balanced and understandable. Secondly, on reviewing and challenging the ongoing effectiveness of the internal control environment and thirdly, on the scope of risk management processes across the Company, including monitoring risk appetite as well as acting as a forum in which to carry out detailed reviews of higher risk areas of operation.

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	Role	Attendance
Neil Cooper	Chairman	5/5
Martin Angle	Non-executive Director	5/5
Martin Hagen	Non-executive Director	5/5
Gill Rider	Non-executive Director	5/5
Lord Matthew Taylor	Non-executive Director	5/5

In addition, the Chairman of the Board has had an open invitation to attend the Audit Committee meetings. In the last year he attended those meetings at which the Committee reviewed the half-year and full-year financial results of the Company.

The following also have a standing invitation to attend South West Water Audit Committee meetings:

- Pennon Group Chief Executive Officer (a member of the South West Water Board)
- Pennon Group Chief Financial Officer
- South West Water Managing Director
- South West Water Finance Director

Other Executive Directors and members of South West Water's Senior Management Team are invited to the Committee as appropriate. The Pennon Group Internal Audit Manager and the Company's external auditor, Ernst & Young LLP also attended the Audit Committee regularly.

In accordance with the UK Corporate Governance Code, the Board is satisfied that Neil Cooper, Martin Angle and Martin Hagen have recent and relevant financial experience. Details of each Director's significant and current experience are set out on pages 33 to 35.

Four members of the South West Water Audit Committee 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.

#### **SIGNIFICANT MATTERS CONSIDERED BY THE AUDIT COMMITTEE**

The calendar of business of the Committee sets in place a framework for ensuring that it manages its affairs efficiently and effectively throughout the year and is able to concentrate on the key matters that affect the Company. The full terms of reference are available on our website ([southwestwater.co.uk](http://southwestwater.co.uk)).

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

<b>Financial reporting</b>	<ul style="list-style-type: none"> <li>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</li> <li>after a detailed review in accordance with its established process, advised the Board that the presentation of the Annual Report and Financial Statements is fair, balanced and understandable in accordance with the reporting requirements and recommend their approval for publication.</li> </ul>
<b>Internal control and compliance</b>	<ul style="list-style-type: none"> <li>review of internal audit reports on core systems and processes across the Company</li> <li>approved updated policies in relation to treasury and going concern assessment</li> <li>reviewed an external quality assessment on the effectiveness of the Internal Audit function</li> <li>monitored performance on specific matters including the internal 'MarketReady' project (in preparedness for the opening of the non-household retail market).</li> </ul>
<b>External auditor</b>	<ul style="list-style-type: none"> <li>considered the auditor's paper report on its audit of the annual results focusing on key findings</li> <li>considered the auditor's report on their review of half year results and key findings</li> <li>considered and approved the audit plan</li> <li>monitored the provision of non-audit services.</li> </ul>
<b>Risk management</b>	<ul style="list-style-type: none"> <li>reviewed the risk management framework and compliance with that framework during the year and after the year-end until the publication of the Company's Annual Report and Financial Statements</li> <li>reviewed the assessment of the risks by the Executive Directors and considered risk appetite</li> <li>reviewed the Company's risk register and considered appropriate areas of focus and prioritisation for the audit work programme for the year</li> <li>received as part of the risk management review the annual report on any whistleblowing.</li> <li>Carried out regular 'deep dives' at Committee meetings on specific areas</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>discussed the results of independent performance evaluation of the Committee, conducted by Armstrong Bonham Carter LLP</li> <li>reviewed new annual report disclosure requirements including the audit report</li> <li>considered and approved accounting policies used in the preparation of the financial statements</li> <li>reviewed and updated Company policies covering treasury and foreign exchange</li> <li>confirmed compliance with South West Water's Code</li> <li>regularly held meetings with the external auditor and the Group Internal Audit Manager without members of management being present.</li> </ul>

In respect of the monitoring of the integrity of the financial statements, which is a key responsibility of the Committee identified in the UK Corporate Governance Code, the significant areas of judgement considered in relation to the financial statements for the year ended 31 March 2017 are set out in the following table, together with details of how each matter was addressed by the Committee. At the Committee's meetings throughout the year the Committee and the external auditor have discussed the significant matters arising in respect of financial reporting during the year and the areas of particular audit focus, as reported on in the independent auditor's report on pages 100 to 107. In addition to the significant matters set out in the table below, the Committee considered a range of other areas including presentational issues, in particular relating to the non-underlying disclosure format and ensuring a fair presentation of statutory and non-statutory performance and financial measures.

<p><b>Area of focus by the Committee: Revenue Recognition</b></p>
<p><b>How the matter was addressed by the Committee:</b>  There were a number of judgement areas in respect of revenue recognition relating to income from measured water services, estimates of timing of receipt of unmeasured revenue. The Committee relied on South West Water's track record of assessing an appropriate level of accrual at previous year ends given actual outturns. The Committee also closely considered the work in respect of these areas at year end by the external auditor as well as reviewing disclosures around revenue recognition accounting policies.</p>

<p><b>Area of focus by the Committee: Bad and doubtful debts</b></p>
<p><b>How the matter was addressed by the Committee:</b>  Regular updates on progress against debt collection targets and other contractual payments due are received by the Board. Performance is monitored regularly against South West Water's historical collection record and the track record of other companies in the sector, including Bournemouth Water, whose operations were merged into South West Water. At the year end the external auditor reported on the work it had performed, which together with the detailed analysis reported enabled the Committee to conclude that the management's assessment of the year-end position was reasonable.</p>

<p><b>Area of focus by the Committee: Going concern basis for the preparation of the financial statements and viability statement</b></p>
<p><b>How the matter was addressed by the Committee:</b>  A report from the Pennon Group Chief Financial Officer on the financial performance of the Group including forward-looking assessments of covenant compliance and funding levels under differing scenarios is provided to the Board on a periodic basis. Rolling five-year strategy projections and the resultant headroom relative to borrowings is also regularly reviewed by the Board, including scenarios to better enable the committee to understand the potential range of outcomes. At the end of each six month period the Chief Financial Officer prepares for consideration by the Committee a report focusing on the Group's liquidity over the 12-month period from the date of signing either the annual report or half-year results. This year the Committee has also considered a report from the Chief Financial Officer on the Group's financial viability over an appropriate period, which the Board considers to be five years, in connection with the new UK Corporate Governance Code requirement for a viability statement to be given by the Board. Consideration of these reports and constructive challenge on the findings of the reports, including the scenario testing carried out by management, has enabled the Committee to form its assessment and satisfy itself that it remains appropriate for the Group to continue to adopt the going concern basis of accounting in the preparation of the financial statements and in addition advise the Board on providing the viability statement set out on page 29 to 30.</p>

## **EFFECTIVENESS OF THE EXTERNAL AUDIT PROCESS**

Receiving high quality and effective audit services is of paramount importance to the Committee. We continue to monitor carefully the effectiveness of our external auditor as well as its independence, bearing in mind that it is recognised there is a need to use our external auditor's firm for certain non-audit services. We have full regard to the Auditing Practices Board's Ethical Standards and ensure that our procedures and safeguards meet these standards.

The current external auditor was appointed following a comprehensive audit tender process undertaken by Pennon Group Plc and approval by shareholders at the Pennon Group Plc 2014 AGM. Their reappointment was approved at the 2016 Pennon Group Plc Annual General Meeting.

The external auditor produced a detailed audit planning report in preparation for the year-end financial statements, which has assisted the auditor in delivering the timely audit of the Company's annual report and financial statements and which was shared with, and discussed by the Committee in advance.

The effectiveness review of the external auditor is undertaken as part of the Pennon Audit and South West Water Audit Committees' annual performance evaluation, which was carried out by independent external consultants, Armstrong Bonham Carter LLP. No issues were raised during that review and the Committees concluded that the auditor was effective during the year. The Pennon Group Audit Committee is responsible for matters relating to appointment and re-appointment of external auditor. It considered that it is appropriate that the external auditor be re-appointed and has made this recommendation to the Pennon Group Board.

The Committee chairman has also met privately with the external auditor.

## **AUDITOR INDEPENDENCE**

The Committee carefully reviews on an ongoing basis the relationship with the external auditor to ensure that the auditor's independence and objectivity is fully safeguarded.

The external auditor reported on their independence in the year and since the year end and confirmed to the Committee that they have complied with the Auditing Practices Board's Ethical Standards and, based on their assessment, that they were independent of the Company.

## **PROVISION OF NON-AUDIT SERVICES**

In line with the requirements of the EU Audit Directive and Regulation which came into force on 17 June 2016, the Committee continues to have a robust policy for the engagement of the external auditor's firm for non-audit work. The policy is for non-audit fees not to exceed 70% of the audit fee for statutory work.

The Committee receives a regular report covering the auditor's fees including details of non-audit fees incurred.

Recurrent fees relate to agreed procedures in relation to annual regulatory reporting obligations to Ofwat, work most efficiently and effectively performed by the statutory auditor. The policy is for non-audit fees not to exceed 70% of the audit fee for statutory work. The Committee carefully reviews non-audit work proposed for the statutory auditor, taking into consideration whether it was necessary for the auditor's firm to carry out such work and would only grant approval for the firm's appointment if it was satisfied that the auditor's independence and objectivity would be fully safeguarded. If there was another accounting firm that could provide the required level

of experience and expertise in respect of the non-audit services, then such firm would be chosen in preference to the external auditor..

The level of non-audit fees payable to the external auditor for the past year is 34.5% of the audit fee, which is well within the Group's 70% non-audit fee limit.

The Pennon Group Chief Financial Officer regularly reports to the Committee on the extent of services provided to the Company by the external auditor and the level of fees paid. The fees paid to the external auditor's firm for non-audit services and for audit services are set out in note 6 to the financial statements on page 121.

Similar restrictions are applicable on a group-wide basis and are summarised in the Pennon Group Audit Committee Report on pages 89 to 90 of the Pennon Group Plc Annual Report 2017.

## **INTERNAL AUDIT**

The internal audit activities of the Company are a key part of the internal control and risk management framework of the Company. There is a long-standing and effective centralised internal audit service, at Pennon Group Plc level, led by an experienced head of function who makes a significant contribution to the ability of the Committee to deliver its responsibilities.

A Company and Group internal audit plan is approved in September each year. It takes account of the principal risks, the activities to be undertaken by the external auditor, and also the Company's annual and ongoing risk management reviews. This approach seeks to ensure that there is a programme of internal and external audit reviews focused on identified key risk areas throughout the Company.

The Group Internal Audit Manager reports regularly to the Committee on audit reviews undertaken and their findings, and there are regular discussions, correspondence and private meetings between the Group Internal Audit Manager and the Committee chairman.

During the year an external assessment of the internal function was performed by KPMG LLP, concluding that the Company's internal audit function conforms to IIA standards issued by the Institute of Internal Auditors. The review highlighted both areas of good practice and some areas for improvement which would improve the delivery of the Company's internal audit function.

## **FAIR, BALANCED AND UNDERSTANDABLE ASSESSMENT**

To enable the Committee to advise the Board in making its statement that it considered that the Company's Annual Report and Accounts is fair, balanced and understandable (FBU) on page 98, the Committee has applied a detailed FBU review framework that takes account of the Group's well-documented verification process undertaken in conjunction with the preparation of the Annual Report and Accounts. This is in addition to the formal process carried out by the external auditor to enable the preparation of the independent auditor's report, which is set out on pages 100 to 107.

In preparing and finalising the 2017 Annual Report and Accounts, the Committee considered a report on the actions taken by management in accordance with the FBU process and an FBU assessment undertaken by each Group 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 Accounts 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.

## **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. The Audit Committee's interactions and engagement into internal audit, including input into the annual plan is summarised above.

### **(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 audits and 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 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.

## **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 23 to 28.

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 November 2016, Ofwat published its assessment of water and sewage companies against its Company Monitoring Framework. The framework adopts a risk based approach with respect to monitoring and assurance requirements for the water companies.

South West Water was assessed within the middle of three categories ('targeted assurance'), following two areas where South West Water had 'minor concerns' with respect to the assessment, six where South West Water met Ofwat's expectations and one where South West Water exceeded Ofwat's expectations.

On or before 15 July 2017, South West Water will publish its Annual Performance Report and Regulatory Reporting as well as a 'Summary Assurance Report.' These reports will include further details on specific assurance South West Water has performed during 2016/17. The Summary Assurance Report will also note actions taken in respect of the Company Monitoring Framework assessment.

In March 2017, following consultation, South West Water published its Assurance Plan. The plan is available on South West Water's website and is in line with the integrated assurance framework which South West Water continues to apply across the business to ensure a robust and rigorous approach to assurance.

The assurance plan consultation included the circulation of a draft plan to South West Water's key stakeholders including customer representative group and publication of the draft plan on our website. Customer and other third party feedback was received, which has been summarised, alongside our response, in the final assurance plan published at [https://www.southwestwater.co.uk/media/pdf/2/g/South\\_West\\_Water\\_Assurance\\_Plan\\_2016-17.pdf](https://www.southwestwater.co.uk/media/pdf/2/g/South_West_Water_Assurance_Plan_2016-17.pdf). We will publish our 2017/18 assurance plan in November 2017.

## 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.

The Committee meets sequentially on the same day as the sustainability committee of Pennon Group Plc. The South West Water Sustainability Committee continues to provide oversight of South West Water's performance against its sustainability targets and the sustainability activities that are core to the successful delivery of South West Water's K6 Business Plan 2015 – 2020. This is consistent with Ofwat's requirement for independent governance of our regulatory business. It specifically 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

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

Membership	Role	Attendance
Gill Rider	Chairman	5/5
Chris Loughlin	Pennon Group Chief Executive	5/5
Stephen Bird	Managing Director	5/5
Martin Angle	Non-executive Director	5/5
Lord Matthew Taylor	Non-executive Director	5/5
Steve Johnson <sup>(1)</sup>	Non-executive Director	1/1

<sup>(1)</sup> Resigned 28 April 2016, recruitment currently ongoing for a replacement

In addition to the members of the Committee, other senior executives attend the meetings to support discussions on their specific areas of expertise.

Neil Cooper stood down from the Committee on 1 April 2016 and Steve Johnson resigned on 28 April 2016, recruitment for his replacement is underway.

During the year the Committee continued to apply the best practice framework published by Business in the Community (BitC), a leading business-led charity that promotes responsible business. The structure provided through BitC's key areas of sustainability (marketplace, workplace, community and environment) is reflected in South West Water's sustainability objectives and supports the development of a range of targets as part of the Company's business planning processes.

As at 31 March 2017 South West Water had achieved eight of its 12 targets for the year. Further details are provided on pages 55 and 56.

The Sustainability Committee operates in the context of the requirement for companies to conduct their business in a responsible manner (in relation to environmental, social and governance (ESG) matters) while at the same time delivering strong financial performance and lasting value for shareholders and other stakeholders. The Sustainability Committee reviews and approves as appropriate the strategies, policies, management, initiatives, targets and performance of the Pennon Group companies in the areas of occupational health and safety and security, environment, workplace policies, responsible and ethical business practice, customer service and engagement, and the role of the Group in society.

#### **THE COMMITTEE'S ACTIVITIES DURING THE YEAR**

Since last year's report, the Committee has considered a wide range of matters in the course of fulfilling its duties in accordance with its terms of reference:

- the Company's health and safety performance and the effectiveness of health and safety policies and procedures
- environmental strategy and performance
- performance in respect of customer service and engagement
- the Company's approach to community relations and investment
- performance against the Company's workplace policy, including review of the results of the employee engagement survey conducted
- sustainable procurement and practices within the supply chain
- sustainability reporting for the 2016/17 and the associated verifier's reports and recommendations.

#### **STRATEGIC SUSTAINABILITY OBJECTIVES**

The Committee has defined the following objectives which drive the sustainability targets set by South West Water. Commentary on our performance against our objectives is integrated throughout the strategic report.

- manage South West Water as a sustainable and successful business for the benefit of our customers, shareholder and other stakeholders
- aim to ensure that all our business activities have a positive economic, social and environmental impact on the communities in which we operate
- engage with our customers and other stakeholders and foster good relationships with them
- strive for the highest standards of health and safety in the workplace so as to minimise accidents, incidents and lost time
- develop and motivate our employees, treat them fairly and ensure that they are fully engaged in all aspects of the South West Water and Pennon Group's objectives and follow the highest standards of business conduct
- aspire to leadership in minimising emissions that contribute to climate change, and develop climate change adaption strategies
- aspire to leadership in all aspects of waste prevention and resource efficiency by delivering solutions for society to address the environmental challenge of depleting natural resources.

#### **SOUTH WEST WATER'S SUSTAINABILITY REPORTING**

Our sustainability reporting is incorporated within this Annual Report and Financial Statements as well as within our Annual Performance Report and Regulatory Reporting.

Full details of our sustainability targets and our performance against them are given in the next section of this report.

## SUSTAINABILITY TARGETS

A summary of South West Water's performance against sustainability targets for 2016/17 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 (6,192 Acres and 990 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 0.242 hours per property	MET
To increase the number of customers assisted through our water affordability initiatives in line with our Business Plans (to over 27,500)	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	NOT MET
Our desire is to have no accidents at work and to achieve a reducing lost time accident frequency rate	NOT MET
To have extended the recruitment of apprentices on our programme by the end of 2015/16 to over 90	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 89% of our customers being satisfied or very satisfied with our overall services	MET
To achieve an average of 61% 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	NOT MET

## VERIFICATION

South West Water's sustainability performance and reporting has been audited by Strategic Management Consultants (SMC), an independent management consultancy specialising in technical assurance in the utility sector.

South West Water considers that SMC's method of verification – which includes testing the assumptions, methods and procedures that are followed in the development of data and auditing that data to ensure accuracy and consistency – complements the best practice insight gained through South West Water's membership of Business in the Community.

# THE NOMINATION COMMITTEE

Consistent with the Group governance approach the Nomination Committee for Pennon Group and South West Water meet sequentially on the same day. Discussions and decisions relating to South West Water are clearly noted within separate minutes.

The Nomination Committee met two times during the year to fulfil the duties set out in its terms of reference. These are available on the Pennon website. The Pennon Nomination Committee met a further two times to consider matters solely relating to Pennon Group Plc.

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.

Matters considered by the Committee during the year included:

- the recruitment for a Non-executive Director (independent of the Pennon Group Plc) to fill the vacancy arising from the resignation of Steve Johnson in April 2016
- the recruitment for a Director of Wastewater Services (an Executive Management Team position) following the resignation of Andrew Willicott in March 2017
- the structure, size and composition of the Board, including the skills, knowledge, independence, diversity and experience of the Directors, taking into account the findings of the independent performance evaluation conducted by Armstrong Bonham Carter LLP for the Pennon Group
- a review of the time spent by Non-Executive Directors in fulfilling their duties and the other directorships they hold
- the Company's performance against its diversity and equality policies
- a review of succession plans, the leadership needs of the Company and approach to succession planning.

It is the practice of the Committee, led by the Chairman, to appoint an external search consultancy to assist in Board appointments to ensure that an extensive and robust search can be made for suitable candidates. Buchanan Harvey & Co, who have no other connection with the Company, were engaged to assist with the recruitment of a non-executive director for the South West Water board (independent of Pennon Group), the process for which is still underway.

## NOMINATION COMMITTEE COMPOSITION AND MEETINGS

Director	Role	Attendance
Sir John Parker	Chairman	2/2
Martin Angle	Non-executive Director	2/2
Neil Cooper	Non-executive Director	2/2
Martin Hagen	Non-executive Director	2/2
Gill Rider	Non-executive Director	2/2
Lord Matthew Taylor	Non-executive Director	2/2

The Pennon Group Chief Executive (a member of the South West Water Board) also attends meetings when invited.

## DIVERSITY POLICY

The Committee is required by the Board to review and monitor compliance with the Board's diversity policy and report on the targets, achievement against these targets and overall compliance in the annual report each year.

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 2017 and as disclosed with the Directors' biographies on page 33 to 35, two of South West Water's Directors are female and therefore South West Water had 22% female representation at Board level, an increase from the 14% female representation at 31 March 2016. While circumstances on occasion will result in changes in Board composition and a lower than targeted female representation percentage, the Board is committed to moving towards a minimum of 25% female representation.

Female membership %	
The Board	22
Executive Management Team	33
Senior Management	20
Company	23

Note: Senior Management includes members of the Executive Management Team.

The proportion of female members of the Senior Management level has decreased from 23% to 20% but we do not view this to indicate a long term trend and female representation in the Company as a whole has increased from 21% to 23%.

## THE REMUNERATION COMMITTEE

Consistent with the Group governance approach the Remuneration Committee for Pennon Group and South West Water meet sequentially on the same day. Discussions and decisions relating to South West Water are clearly noted within separate minutes.

The Committee met seven times during the year to fulfil the duties set out in its terms of reference. In particular, the Committee is responsible for:

- ensuring remuneration is aligned with and supports the Company's strategy; reflects the values as a Company and optimises performance
- reviewing the remuneration policy necessary to ensure it remains appropriate and fulfils its purpose of attracting and retaining 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 seven meetings of the South West Water Remuneration Committee meetings in the year. Members of the Committee and their attendance were as follows:

Membership	Date of appointment		Attendance
Martin Angle	1 April 2016	Chairman of the Committee	7/7
Neil Cooper	1 April 2016	Non-executive Director	6/7
Martin Hagen	1 September 2013	Non-executive Director	7/7
Gill Rider	1 April 2016	Non-executive Director	7/7
Steve Johnson <sup>(1)</sup>	1 September 2014	Non-executive Director	1/1

<sup>(1)</sup> Resigned 28 April 2016, recruitment currently ongoing for a replacement

In accordance with the Code, all of the Committee members are independent Non-Executive Directors, and the Committee is advised by Deloitte, an independent remuneration consultant, to ensure remuneration is determined impartially. The Chairman of the Board attends from time to time but is not a member of the Committee and the Pennon Group Chief Executive Officer (who is also a member of the South West Water Board) also attends meetings when invited except for such part of a meeting when matters concerning his own remuneration are to be discussed.

## **THE COMMITTEE'S ACTIVITIES DURING THE FINANCIAL YEAR**

The Committee engaged in the following activities during the year:

- Annual executive salary review
- Annual review of the Chairman's fee
- Determining performance targets in respect of the Annual Incentive Bonus for 2016/17
- Reviewing drafts of the Directors' remuneration report for 2016/17 and recommending to the Board for approval for inclusion in the 2016 Annual Report
- Determining bonuses and deferred bonus awards pursuant to the Company's Annual Incentive Bonus Plan in respect of the year 2015/16
- Noting the Performance and Co-investment Plan awards for the year
- Noting the release of 2013 deferred bonus share awards and the vesting of executive share options pursuant to the Annual Incentive Bonus Plan
- Considering and debating issues relating to the review of the remuneration policy and future arrangements for the annual bonus and long-term incentive plan (LTIP), with a particular focus on performance metrics and incentive levels to ensure these are aligned with the new management structure and strategic objectives
- The results of independent performance evaluation of the Committee, conducted by Armstrong Bonham Carter LLP

## **THE COMMITTEE'S FOCUS FOR 2017/18**

- Ensure that targets are stretching but also fair and achievable, so that they act to retain, motivate and incentivise management to deliver the Company's strategic goals and to create long-term value for shareholders
- Improve the process around, and disclosure of, personal bonus targets
- Monitor on an ongoing basis the alignment of executive pay and benefits with the strategic direction of the Company.

## **THE DIRECTORS' REMUNERATION REPORT**

The Directors' remuneration report for 2016/17 is set out separately on pages 65 to 80.

## SOUTH WEST WATER'S EXECUTIVE MANAGEMENT TEAM

The Managing Director, Dr Stephen Bird, is responsible for all of South West Water's executive matters.

Day to day management of South West Water's operations and activities is undertaken by South West Water's Executive Management Team, which as at 31 March 2017 comprised six members and operates under the direction and authority of the Managing Director. The team comprises a mixture of both Executive Directors and six other operational leaders, each of whom brings extensive skills and expertise relevant to their area of responsibility. Collectively the Executive Management Team are responsible for delivering operational and financial performance in line with the Board's strategic direction.

The team includes Dr Stephen Bird (Managing Director) and Louise Rowe (Finance Director), who are also members of South West Water's Board and whose experience is described on page 34. The four further members of the Executive Management Team, who have responsibility for key areas of operations of South West Water, and their experience is as follows:

<b>Bob Taylor</b> Operations Director (Drinking Water Services)	<b>Graham Murphy</b> Engineering and Supply Chain Director	<b>Iain Vosper</b> Regulation Director	<b>Jo Ecroyd</b> Customer Service Director
<b>Experience</b>			
<p>Bob joined South West Water's Executive Management team on 1 January 2016.</p> <p>He was Managing Director of Bournemouth Water from April 2015 until the merger of its operations into South West Water in April 2016, having previously served as Bournemouth Water's Operations Director as well as a number of senior roles within Sembcorp.</p> <p>He has previously held a wide number of Managing Director and other senior positions within both UK and overseas water and utility companies.</p> <p>Bob has masters degrees in both Public Health Engineering and in Business Administration.</p>	<p>Graham joined South West Water in 1991 and has held a number of managerial roles across the business.</p> <p>He is now responsible for the delivery of the Company's capital investment programme (including the new Mayflower Treatment Works) and the development of the capital maintenance and supply and demand elements of the business plan.</p> <p>Prior to working at South West Water, Graham held a number of posts within British Gas.</p> <p>He is a Chartered member of the Institution of Personnel and Development as well as the Institution of Gas Engineers and Management and has a Masters in Business Administration.</p>	<p>Iain is a Chartered Accountant who joined South West Water in 2008 following both audit and senior financial roles.</p> <p>He has held a range of financial and operational managerial roles within South West Water.</p> <p>He was Programme Manager for the 2014 price review, when South West Water's business plan for 2015-20 was recognised as one of only two in the UK water industry with 'enhanced status' by the industry regulator, Ofwat.</p> <p>Iain is responsible for compliance with regulatory and environmental obligations and for the asset management strategy and our new Wholesale Service Desk, which interacts with water retail companies in the newly established non-household market.</p>	<p>Jo joined South West Water in 2006 as Service Centre Manager and has held a variety of customer service and service improvement focused roles.</p> <p>In October 2016 she was promoted to Customer Service Director, joining the Executive Management Team.</p> <p>She has overall responsibility for services provided to South West Water's household customers, as well as for all customer service interactions with household customers.</p>

In March 2017 Andrew Willicott (Operations Director, Waste Water Services), who had been a member of the Executive Management Team resigned. A process is underway to recruit a replacement member of the team.

The Executive Management Team have established a number of sub-boards and committees to oversee core strategic priorities and specific areas of governance requiring regular focus and attention. The key boards and sub-committees are detailed below:

<b>Outcome Delivery Incentive (ODI) Board</b>
<p>Following extensive customer and other stakeholder consultation during the 2014 periodic review, performance commitments were identified against key customer priority areas. Each of these performance commitments is incentivised under the current regulatory framework with either financial or reputational incentives (Outcome Delivery Incentives).</p> <p>This board has been established to oversee South West Water's plans to deliver the commitments it has made to customers and stakeholders over the 2015-20 period.</p> <p>It meets monthly, includes members of the Executive Management and relevant Senior Managers responsible for the delivery of South West Water's performance commitments.</p>

<b>Investment Planning Committee (IPC)</b>
<p>South West Water's Investment Planning Committee (IPC) effectively owns South West Water's Investment Planning and Control procedures which controls the way capital investment is decided and approved including all project expenditure approvals. The purpose of the procedures is to ensure that the principles of proper financial control are applied throughout the inception, evaluation, implementation and handover of the investment being considered.</p> <p>The Committee operates under a structured delegation of authority. Certain investments require direct approval of the Board.</p> <p>The IPC comprises all members of South West Water's Executive Management Team as well as a number of Senior Managers drawn from South West Waters Drinking Water and Waste Water Operations as well as Engineering and Finance teams.</p>

<b>Contract Strategy Group (CSG)</b>
<p>The role of the Group is to develop and maintain strategies and policies to promote effective working practices in relation to the SWW's strategic contracting relationships.</p> <p>The role of this group includes developing the overarching governance framework for the procurement of goods and services, planning for and monitoring procurement and contracting approaches, reviewing recommendations for the award of strategic contracts prior to other required approvals in line with delegated authority limits.</p> <p>Its responsibilities also include considering any interdependencies and potential impact on other contracts as well as compliance with EU procurement legislation and the promotion of sustainable procurement.</p> <p>A group level contract strategy body is being established.</p>

<b>Health and Safety Steering Group (HSSG)</b>
<p>The Health and Safety Steering Group, chaired by South West Water's Managing Director, meets on a quarterly basis.</p> <p>The group oversees South West Water's approach to Health, Safety and staff welfare and receives quarterly presentations from each operational area of the business (such as Drinking Water, Wastewater and Retail) regarding performance in the preceding quarter.</p> <p>The group also reviews the effectiveness of ongoing initiatives (such as 'Quest,' 'Think, Act, Prevent,' and 'Hang On A Sec') and performs more detailed hazard reviews.</p> <p>The group also monitors health and safety procedures in place within and performance of our key strategic partners.</p> <p>It feeds into a Pennon Group level equivalent. Health and Safety is also the first item on each Board agenda.</p>

### **Risk and Assurance Forums**

South West Water's Risk and Assurance forums meet on a quarterly basis 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.

The forums also receive reports concerning assurance being performed in line with South West Water's integrated assurance framework. In particular updates are received at each forum by the Group Internal Audit Manager and South West Water's internal Risk and Compliance function.

South West Water's Managing Director, Finance Director and Regulatory Director and the Pennon Group Internal Audit Manager attend all forums, with other members of the Executive Management Team and Senior Management attending when relevant risks and assurance work is being considered.

The South West Water forums feed into Group Risk Forums, chaired by the Pennon Group Chief Financial Officer, which consider and oversee risk management across the group.

### **SIGNIFICANT PROJECT GOVERNANCE**

South West Water also establishes project steering boards for projects which are significant to the strategy and operations of the business and which require significant levels of oversight. During 2016/17 project steering boards were operating for the following key projects:

- 'MarketReady' – South West Water's internal programme to ensure it was ready to comply with and fully participate with the non-household retail market from 1 April 2017. The steering board oversaw the preparations for market opening and in particular assurance being performed in respect of preparedness.
- Periodic Review 2019 (PR19) – This project steering board was established in 2016/17 to oversee South West Water's preparations, planning and delivery of its business plan for the 2020-25 regulatory revenue control period.

Each of the project boards established includes all relevant members of the Executive Management Team and meets on a monthly basis, receiving status reports from those managing and delivering the projects.

# DIRECTORS' REMUNERATION AT A GLANCE

## KEY COMPONENTS OF EXECUTIVE DIRECTORS' REMUNERATION

<b>Base salary</b>	Set at a competitive level to attract and retain high calibre candidates to meet Company's strategic objectives in an increasingly complex business environment.
<b>Benefits</b>	Benefits provided are consistent with the market and level of seniority and to aid retention of key skills to assist in meeting strategic objectives.
<b>Annual bonus</b>	Incentivises the achievement of key performance objectives aligned to the strategy of the Company.
<b>Long-term incentive plan</b>	Provides alignment to the achievement of the Company's strategic objectives and the delivery of sustainable long-term value to shareholders.
<b>Shareholding guidelines</b>	Create alignment between executives and shareholders and promote long-term stewardship.
<b>Pension</b>	Provides funding for retirement and aids retention of key skills to assist in meeting the Company's strategic objectives.
<b>All-employee share plans</b>	Align the interests of all employees with Pennon Group Plc's share performance.

## SUMMARY OF DIRECTORS' REMUNERATION 2016/17

	Base salary/fees (£000)	Benefits (including sharesave) (£000)	Annual bonus (cash bonus and deferred shares) (£000)	Long term incentive plan (£000)	Pension (£000)	Total remuneration (£000)
<b>Executive Directors</b>						
Chris Loughlin <sup>(1)</sup>	255	13	215	100	77	660
Stephen Bird	240	20	158	71	78	567
Louise Rowe	140	10	96	-	22	268
<b>Non-executive Directors</b>						
Sir John Parker <sup>(1)</sup>	133	-	-	-	-	133
Martin Angle <sup>(1)</sup>	33	-	-	-	-	33
Neil Cooper <sup>(1)</sup>	33	-	-	-	-	33
Martin Hagen	50	-	-	-	-	50
Gill Rider <sup>(1)</sup>	36	-	-	-	-	36
Lord Matthew Taylor	50	-	-	-	-	50
D Ingram	4	-	-	-	-	4
S Johnson	8	-	-	-	-	8

(1) These directors are also Directors of Pennon Group Plc. The disclosures above reflect 50% of their full remuneration which is rechargeable to South West Water through group recharges. The full single total figure of remuneration tables are show on page 83.

## KEY CHANGES IN POLICY AND IMPLEMENTATION

<b>Performance measurement</b>	Re-shaping our performance measurement framework to align with the strategic priorities of the Company and Pennon Group - for both the annual bonus and the Long Term Incentive Plan (LTIP).
<b>Holding period</b>	Formalising the existing two year holding period.
<b>Long Term Incentive Plan (LTIP) opportunity</b>	A proposed increase to our LTIP opportunity to align it better with the market, aiding retention and recruitment – the first increase to incentive quantum we have made for 10 years.
<b>Shareholding guidelines</b>	Increasing the Pennon shareholding guidelines for specific Executive Directors, to provide stronger alignment with long-term strategy.

Read more about the key changes in policy and implementation on pages 69 to 70.

# DIRECTORS' REMUNERATION REPORT

Our remuneration arrangements ensure the commitment of our Executive Directors to our long-term strategic objectives.

## INTRODUCTION

A revised Directors' Remuneration Policy Report (Policy) is proposed following the expiration of a three year period, aligned with proposed changes for Pennon Group Plc. As explained below, the revised Policy follows the first review of incentive levels for ten years and reflects the major changes Pennon has made to its strategy, management structure and governance in the last year. This includes the appointment of Chris Loughlin to the newly created role of Pennon Group Chief Executive Officer, leading a new, restructured Pennon Executive team. It also reflects the challenges we face in the recruitment and retention of executive talent.

In addition, our long-term incentive plan will expire this year, and a new plan will be put to shareholders for approval.

On pages 81 to 93 we set out our annual report on remuneration which contains the remuneration of the Directors for the year 2016/17 including the 'single remuneration figure' table. It also provides details on how our policy will be applied for 2017/18. This is subject to approval by Pennon Group Plc shareholders at its AGM in July 2017.

## POLICY REVIEW

Over the last year Pennon Group has have undertaken a comprehensive review of all aspects of the Pennon executive remuneration arrangements. A particular focus was given to looking at our performance measurement framework afresh, to ensure its continued relevance and alignment with strategy and consistency with best practice. Throughout the process, the Committee has received advice from its remuneration advisers Deloitte LLP, and from the Board Chairman.

This has been the first review of incentive levels for ten years and, while a number of best practice features have been adopted in recent years, our review sought to address recent challenges that Pennon and South West Water has faced in recruiting talent in a changing talent pool and business environment.

Our objective continues to be to have in place remuneration arrangements that ensure the commitment of our Executive Directors to our long-term strategic objectives and to the creation of shareholder value, whilst ensuring their behaviours reflect the values of the organisation and actions are taken in accordance with our high standards of governance.

## REMUNERATION REVIEW – THE KEY PRINCIPLES WE FOLLOWED

- Align executive targets with the Company's key strategic objectives
- Attract and retain high calibre executives in an increasingly competitive talent market
- Ensure a transparent, simple and equitable approach to pay
- Incentivise the delivery of sustainable long term value to shareholders
- Drive the right behaviours at all times from executives
- Support the underlying strategic priorities of operating safely, with an engaged workforce and focus on customer service
- Improve transparency and line of sight under performance measurement framework
- Apply similar remuneration principles across the Pennon Group.

## PROPOSED POLICY MODIFICATIONS

As a result of our review, we are proposing some modifications to our remuneration policy, including a refreshed approach to our performance measurement framework, with metrics which are strongly aligned to our strategy.

- **LTIP performance measures** – introduction of new performance metrics under our LTIP, aligned with Pennon Group key strategic objectives. For 2017/18, LTIP awards will be based on a combination of EPS growth, dividend growth/dividend cover, and return on capital employed (ROCE). These metrics align executives with the delivery of sustainable earnings and related cashflows, as well as Pennon's sector-leading dividend policy. This moves away from the historic approach of using only Total Shareholder Return (TSR). The review highlighted that it has become increasingly difficult to formulate a robust sector comparator group, and a FTSE 250 group is often counter cyclical to Pennon's sector
- **LTIP opportunity** – a proposed increase to our LTIP opportunity – the first increase to incentive quantum we have made for ten years. Under the proposed new policy, the maximum opportunity for executive directors will be increased from 100% to 150% of salary. Our recent experience in recruitment has led us to believe that we are not sufficiently competitive in the market. While careful consideration was given to the current climate, the Committee strongly believes that it is in shareholders' interests to enable Pennon to compete for talent on a level playing field, securing an executive team who can deliver long-term business success. Our incentive levels will continue to be positioned conservatively against the market. As a Committee we also recognise the importance of stretching performance metrics in circumstances where we are seeking a higher maximum reward
- **LTIP simplification and performance alignment** – simplification of our long-term incentive framework with the removal of the co-investment element under the new LTIP. In addition, vesting for threshold performance will be reduced from 30% to 25%
- **Annual bonus performance measures** – an increase in the combined weighting on Pennon Group financial metrics as well as the key operational measures on which performance is assessed by our regulator, customers, communities and wider stakeholders. We are not proposing any change to the existing policy that 50% of any bonus is deferred into Pennon Group Plc shares which are normally released after three years
- **Shareholding guidelines and long term-stewardship** – for South West Water we have retained the size of the shareholding in Pennon Group Plc expected to be held by the Executive Directors at 100% of salary. The Pennon Group Chief Executive Officer (who is also a Director of South West Water) is significantly increased from 100% to 200% of salary. This is to enhance the focus on long-term stewardship and provide a stronger alignment with Pennon shareholders.
- **Holding periods** - we introduced two-year holding periods in 2015. We are retaining this feature and are formalising it as part of our policy.

Further details on the remuneration policy are set out on pages 68 to 80.

## OVERALL PERFORMANCE ACHIEVED DURING THE YEAR

The Pennon Group and South West Water achieved a strong performance in 2016/17 delivering against its strategic objectives. South West Water's return on regulated equity (RORE) at 12.6% continues to lead the sector.

## **KEY REMUNERATION DECISIONS**

For 2017/18, salaries for executive directors were increased by 1.5%, in line with increases awarded to the wider employee population, except for Louise Rowe, who received an increase of 14.3% reflecting her performance and experience gained in the role of Finance Director since her appointment on 1 February 2015.

The bonus outturns for the Executive Directors for 2016/17 reflect the achievements of the Company (or group where appropriate), the Company's performance against corporate financial targets and the Executive Directors' performance against individual targets. Half of the bonus is deferred into Pennon Group Plc shares. Further details of targets, measures and performance are set out on pages 81 and 82.

As regards the Company's long-term incentive plan, the overall estimated outturn for awards vesting in 2017 at the end of the three year period is 43.7% of the maximum 100% for Chris Loughlin and 80% for Stephen Bird. This reflects that the Pennon Group's total shareholder return is estimated to exceed above the comparator index performance and the FTSE 250 group.

## **BOARD CHANGES**

On 1 April 2016 three existing Pennon Non-executive Directors, Martin Angle, Neil Cooper and Gill Rider, were appointed to the South West Water Board. On 28 April 2016 Steve Johnson resigned following his appointment to a new external executive position. Recruitment of a new Non-executive Director is being progressed.

## **LOOKING FORWARD**

We will continue to review our remuneration arrangements and performance measures to ensure they are aligned with our strategy.

# DIRECTORS' REMUNERATION POLICY

## INTRODUCTION

The remuneration policy described in this part of the report is intended to apply to the Company, subject to a binding vote of Pennon Group shareholders, following the Group's 2017 AGM which is scheduled to be held on 6 July 2017.

This will approve a revised long-term incentive plan (LTIP), which will replace the current Performance and Co-investment Plan (PCP), which will expire in July 2017.

The Directors' remuneration policy will be displayed on the Company's website at [www.pennon-group.co.uk/about-us/governance-and-remuneration](http://www.pennon-group.co.uk/about-us/governance-and-remuneration), immediately after the 2017 AGM and will be available upon request from the Group Company Secretary.

## CHANGES TO THE REMUNERATION POLICY

The Pennon Group Remuneration Committee undertook a comprehensive review of the remuneration policy following the end of a three year period, as well as the expiry of our long-term incentive plan (the existing PCP will expire in July 2017). Following this review, which included a consultation process with Pennon's largest shareholders, the key changes to the policy include:

- Re-shaping our performance measurement framework to align with strategic priorities
- A proposed increase to our LTIP opportunity to align it better with the market, aiding retention and recruitment – the first increase to incentive quantum for 10 years
- Formalising our existing two year holding period
- Increasing shareholding guidelines for the Pennon Group Chief Executive (who is also an Executive Director of South West Water).

**SUMMARY OF KEY CHANGES TO THE REMUNERATION POLICY**

<b>Component</b>	<b>Existing policy</b>	<b>New policy</b>	<b>Rationale and link to strategy</b>
<b>Annual bonus</b>	<p><i>Performance measures</i> Performance targets relate to corporate and personal objectives. Normally 70% relates to financial targets or quantitative measures.</p> <p><i>Maximum award</i> Chris Loughlin – 100% of salary Stephen Bird/Louise Rowe – 75% of salary</p> <p><i>Deferred element</i> A proportion (usually 50%) of any bonus is deferred into shares in the Company which are normally released after three years.</p>	<p><i>Performance measures</i> Increase in the portion of the award relating to financial KPIs or quantitative operational measures.</p> <p><i>Maximum award</i> No changes to the policy</p> <p><i>Deferred element</i> No changes to the policy</p>	<p><i>Performance measures</i> Improved focus on Group measures and reflects new Group management structure. Strong link to measureable financial and operational KPIs which underpin the delivery of our strategy and value to shareholders and our customers.</p> <p><i>Maximum award</i> No changes to the policy</p> <p><i>Deferred element</i> No change to the policy.</p>
<b>LTIP</b>	<p><i>Performance measures</i> Total Pennon shareholder return (TSR) against the performance of a water/waste peer group index and constituents of the FTSE 250 index (excluding investment trusts).</p> <p><i>Co-investment requirement</i> Requirement to acquire co-investment shares equivalent to one-fifth of the value of the award.</p> <p><i>Maximum award</i> Maximum award of 100% of salary for Chris Loughlin and 80% of salary for Stephen Bird and Louise Rowe.</p> <p><i>Threshold vesting</i> 30% of maximum award</p> <p><i>Holding periods</i> Two-year holding periods were introduced for awards made from 2015.</p>	<p><i>Performance measures</i> A combination of Pennon EPS growth, sustainable dividend growth and dividend cover, and return on capital.</p> <p><i>Co-investment requirement</i> No co-investment requirement under the new policy.</p> <p><i>Maximum award</i> Maximum award of 150% as a percentage of salary for Chris Loughlin and 80% for Stephen Bird and Louise Rowe</p> <p><i>Threshold vesting</i> 25% of maximum award</p> <p><i>Holding periods</i> Two-year holding periods will continue to apply (and will be formally included in Policy).</p>	<p><i>Performance measurement framework</i> more closely aligned to Pennon's strategy.</p> <p>Move away from Pennon TSR due to increasing challenge in forming robust and relevant comparator group due to sector consolidation.</p> <p><i>Co-investment requirement</i> Simplification of our long-term incentive framework.</p> <p>Shareholdings requirements will increase (see below) but are no longer linked to the LTIP.</p> <p><i>Maximum award</i> Ensure we compete for high calibre talent on a level playing field. Following the increase, Pennon will continue to be positioned conservatively against the market.</p> <p><i>Threshold vesting</i> Reduced threshold vesting to reflect best practice and deliver reward for superior performance.</p> <p><i>Holding periods</i> Extend time horizons to five years and enhance long-term focus of executives.</p>

Component	Existing policy	New policy	Rationale and link to strategy
Shareholding requirements	100% of salary for Executive Directors	200% of salary for Chris Loughlin, the Pennon Group Chief Executive Officer and 100% of salary for the South West Water Managing Director and South West Water Finance Director.	Strengthen alignment of executives with shareholders and promote long-term stewardship.

#### 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 the Directors' remuneration policy.

How the components support the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of payment)	Maximum potential value of the component	Description of framework used to assess performance
<b>Base salary</b>			
<p>Set at a competitive level to attract and retain high calibre candidates to meet Company's strategic objectives in an increasingly complex business environment.</p> <p>Base salary reflects the scope and responsibility of the role as well as the skills and experience of the individual.</p>	<p>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.</p> <p>However, the Committee reserves the right to make increases above those made to general employees, for example in circumstances including (but not limited to) an increase in the scope of the role.</p>	<p>When reviewing salaries the Committee has regard to the following factors:</p> <ul style="list-style-type: none"> <li>• Salary increases generally for all employees in the Company</li> <li>• Market rates</li> <li>• Performance of individual and the Company</li> <li>• Other factors it considers relevant</li> </ul> <p>There is no overall maximum</p>	<p>None, although individual and Company performance are factors considered when reviewing salaries.</p>
<b>Benefits</b>			
<p>Benefits provided are consistent with the market and level of seniority to aid retention of key skills to assist in meeting strategic objectives.</p>	<p>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.</p> <p>In the event that an Executive Director is required to relocate, relocation benefits may be provided.</p>	<p>The cost of insurance benefits may vary from year to year depending on the individual's circumstances.</p> <p>There is no overall maximum benefit value but the Committee aims to ensure that the total value of benefits remain proportionate.</p>	<p>None.</p>

FUTURE POLICY TABLE – EXECUTIVE DIRECTORS continued

How the components support the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of payment)	Maximum potential value of the component	Description of framework used to assess performance
<b>Annual bonus</b>			
<p>Incentivises the achievement of key performance objectives aligned to the strategy of the Company.</p>	<p>Annual bonuses are calculated following finalisation of the financial results for the year to which they relate and are usually paid three months after the end of the financial year.</p> <p>A portion of any bonus is deferred into shares in the Company 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>Malus and clawback provisions apply which 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 100% of base salary for Chris Loughlin and 75% for Stephen Bird and Louise Rowe.</p>	<p>Performance targets relate to corporate and personal objectives which are reviewed each year.</p> <p>For 2017/18, performance measures will be weighted as follows:</p> <ul style="list-style-type: none"> <li>• 50% profit before tax</li> <li>• 10% return on regulated equity</li> <li>• 20% operational measures (all of these measures will be subject to defined quantitative targets)</li> <li>• 20% personal objectives</li> </ul> <p>The measures, weighting and threshold levels may be adjusted for future 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 in exceptional circumstances may exercise its discretion and adjust the bonus to reflect any specific factors.</p>

FUTURE POLICY TABLE – EXECUTIVE DIRECTORS continued

How the components support the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of payment)	Maximum potential value of the component	Description of framework used to assess performance
<b>Long-term incentive plan (LTIP)</b>			
<p>Provides alignment to the achievement of the Company's strategic objectives and the delivery of sustainable long-term value to shareholders.</p>	<p>Annual grant of conditional shares (or equivalent). Share awards vest subject to the achievement of specific performance conditions measured over a performance period of no less than three years.</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>For grants made in 2015 and 2016 onwards under the PCP, as well as all grants made from 2017 under the LTIP, malus and clawback provisions 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) material misstatement, serious reputational damage, or the participant's misconduct.</p> <p>The circumstances in which clawback may be applied are material misstatement or serious misconduct.</p> <p>In addition a 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 may be applied during the three year performance period and clawback may be applied up until the end of the holding period.</p>	<p>The maximum annual award is 150% of base salary for Chris Loughlin and 80% for Stephen Bird and Louise Rowe.</p>	<p>The current performance measures for the LTIP are based on a combination of growth in earnings per share (EPS), sustainable dividend growth and dividend cover, and return on capital.</p> <p>For 2017/18 awards, performance measures will be weighted as follows:</p> <ul style="list-style-type: none"> <li>• 40% based on Pennon EPS growth</li> <li>• 40% based on a combination of Pennon dividend growth and a dividend cover metric</li> <li>• 20% based on Pennon return on capital employed</li> </ul> <p>The "underpin" evaluation includes consideration of environmental, social and governance (ESG) factors and safety performance as well as financial performance.</p> <p>No more than 25% of maximum vests for minimum performance.</p> <p>The Committee will keep the performance measures and weightings 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, as well as the impact of regulatory changes.</p>

**Long term incentive plan (LTIP) commitments made under the 2014 policy**

Performance conditions set under the previous remuneration policy (approved at the 2014 Pennon Group AGM) will continue to apply to awards granted in 2014, 2015 and 2016. These awards are due to vest in 2017, 2018 and 2019 respectively. Previous performance conditions were based on Pennon Group Plc total shareholder return (TSR) against the performance of a water/waste peer group index and constituents of the FTSE 250 index (excluding investment trusts). For awards granted under the 2014 remuneration policy, no more than 30% of the maximum vests for minimum performance.

**FUTURE POLICY TABLE – EXECUTIVE DIRECTORS** continued

How the components support the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of payment)	Maximum potential value of the component	Description of framework used to assess performance
<b>Shareholding requirements</b>			
Create alignment between executives and shareholders and promote long-term stewardship.	Currently 200% of salary for Chris Loughlin, the Pennon Group Chief Executive Officer and 100% of salary for Stephen Bird, the South West Water Managing Director and Louise Rowe, the South West Water Finance Director.		
<b>Pension</b>			
Provides funding for retirement and aids retention of key skills to assist in meeting the Company's strategic objectives.	<p>Defined benefit pension arrangements are closed to new entrants. Defined contribution pension arrangements 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:</p> <ul style="list-style-type: none"> <li>• 30% of salary for Chris Loughlin</li> <li>• 21% of salary for Stephen Bird</li> <li>• 15% of salary for Louise Rowe</li> </ul> <p>Legacy defined benefit pension arrangements will continue to be honoured.</p> <p>Whilst one Executive Director is a pension member there are no further prospective accruals in respect of defined benefit pension arrangements.</p>	None.
<b>All-employee share plans</b>			
Align the interests of all employees with Pennon Group Plc share performance.	Executive Directors may participate in HMRC approved all-employee plans on the same basis as employees.	The maximum is as prescribed under the relevant HMRC legislation governing the plans.	None.

## NOTES TO THE FUTURE POLICY TABLE – EXECUTIVE DIRECTORS

### *OPERATION OF EXECUTIVE SHARE PLANS*

The long-term incentive plan will be operated in accordance with the rules of the plan as approved by Pennon Group shareholders. The deferred bonus awards will be governed by the rules adopted by the Board from time to time. Awards under any of the Pennon Group's share plans referred to in this report may:

- Be granted as conditional share awards, nil-cost options or in such other form that the Committee determines has the same economic effect
- Have any performance conditions applicable to them amended or substituted by the Committee if an event occurs which causes the Committee to determine an amended or substituted performance condition would be more appropriate and not materially less difficult to satisfy
- Incorporate the right to receive an amount (in cash or additional shares) equal to the value of dividends which would have been paid on the shares under an award that vest up to the time of vesting (or where the award is subject to a holding period, release). This amount may be calculated assuming that the dividends have been reinvested in the Pennon Group's shares on a cumulative basis
- Be settled in cash at the Committee's discretion.

### *PRE EXISTING COMMITMENTS*

The Committee reserves the right to make any remuneration payments and/or payments for loss of office (including exercising any discretion available in connection with such payments) outside the policy set out above where the terms of the payment were agreed (i) before Pennon Group AGM 2014 (the date the Pennon Group's first shareholder-approved directors' remuneration policy came into effect); (ii) before the policy set out above came into effect, provided that the terms of the payment were consistent with the shareholder-approved directors' remuneration policy in force at the time they were agreed; or (iii) at a time when the relevant individual was not a director of the Company and, in the opinion of the Committee, the payment was not in consideration for the individual becoming a director of the Company. For these purposes "payments" includes the Committee satisfying awards of variable remuneration and, in relation to an award over shares, the terms of the payment are "agreed" at the time the award is granted.

The Executive Share Option Scheme (ESOS) which, under the 2014 remuneration policy, operated in conjunction with the deferred element of the annual bonus, has been removed. No ESOS options have been offered to Executive Directors since 2013.

### *EARLY VESTING EVENTS*

On a change of control or voluntary wind up of the Company, LTIP awards may vest to the extent determined by the Committee having regard to the performance of Pennon Group and the period of time that has elapsed since grant. Deferred bonus awards may vest in full. Alternatively, participants may have the opportunity, or be required, to exchange their awards for equivalent awards in another company, although the Committee may decide in these circumstances to amend the performance conditions.

The Committee also has the discretion to treat any variation of the Pennon's share capital or any demerger, special dividend or other transaction that may affect the current or future value of awards as an early vesting event on the same basis as a change of control.

## *AMENDMENTS TO THE REMUNERATION POLICY*

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

## *PERFORMANCE MEASURES AND TARGETS*

The performance conditions for the annual bonus plan are selected by the Committee each year to reflect key performance indicators for the Company and key metrics used by the Board to oversee the operation of the business.

In respect of the LTIP, performance conditions for 2017/18 awards will be Pennon Group EPS growth and a sustainable dividend metric (comprising dividend growth and dividend cover) and return on capital employed (ROCE). The Committee chose these measures as they are closely aligned with Pennon's strategic focus on the delivery of sustained earnings and related cash flows, as well as our sector-leading dividend policy.

ROCE also measures the long-term capital returns generated by our businesses. The performance targets are set in the context of the Group's forecasts and market expectations.

The Committee may amend future performance measures, weightings and targets, in the context of the Company's strategy, the impact of changes to the regulatory framework, accounting standards and any other relevant factors.

The measurement of performance against performance targets is at the Committee's discretion, which may include appropriate adjustments to financial or non-financial elements and/or consideration of overall performance in the round.

Performance conditions may also be replaced or varied if an event occurs or circumstances arise which cause the Committee to determine that the performance conditions have ceased to be appropriate. If the performance conditions are varied or replaced, the amended conditions must, in the opinion of the Committee, be fair, reasonable and materially no less difficult than the original condition when set.

The Committee would consult with major shareholders of Pennon Group Plc in advance of any proposed material change in performance measures.

## *DIFFERENCES IN REMUNERATION POLICY FOR ALL EMPLOYEES*

When setting remuneration for Executive Directors the Committee considers relevant information about pay and conditions in the Company and Group. Senior executives and Executive Directors generally receive a higher proportion of their total pay in the form of variable remuneration and share awards. All administrative employees of South West Water are entitled to base salary and pension provision including life assurance. In addition all administrative staff in South West Water are entitled to participate in annual bonus arrangements, the levels of which are based on the seniority and level of responsibility.

Long-term incentive share awards are only available to senior executives and Executive Directors, and certain benefits are generally available only to more senior employees at management level and above.

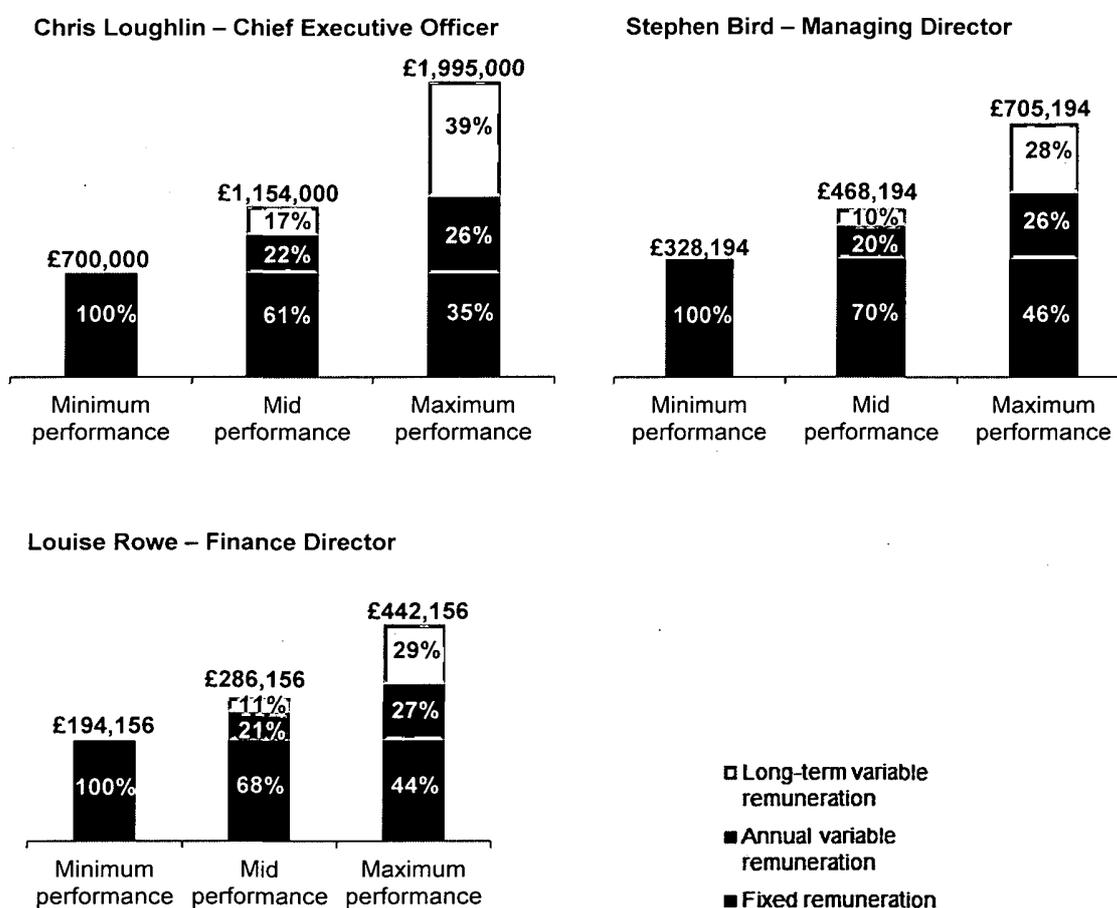
**FUTURE POLICY TABLE – NON-EXECUTIVE DIRECTORS**

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
<b>Fees</b>		
<p>Set at a market level to attract Non-executive Directors who have appropriate experience and skills to assist in determining the Group's and South West Water'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 or occupying the role of Senior Independent Director.</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>
<b>Benefits</b>		
<p>The benefits provided for the Chairman 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's benefits include the provision of a driver and vehicle, when appropriate for the efficient carrying out of his duties.</p>	<p>None.</p>

## ILLUSTRATIONS OF APPLICATIONS OF REMUNERATION POLICY

The total annual remuneration for the Executive Directors that could result from the proposed remuneration policy, based on salaries for 2017/18 is shown below.



Scenario	Assumptions
<b>Fees</b>	
Minimum performance	Fixed pay, which constitutes base salary, pension and benefits in kind. These values are made up of the salaries for 2017/18 (set out on page 83) and an estimate of the value of the benefits and pension.
Mid performance	Fixed pay and 50% of the maximum annual bonus and 25% of the maximum long term incentive award.
Maximum performance	Fixed pay and 100% vesting of the annual bonus and of long-term incentive awards.

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

## APPROACH TO RECRUITMENT REMUNERATION

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

The Committee will appoint new Executive Directors with a package that is in line with the remuneration policy that is in place at the time. Base salary may be set at a higher or lower level than the previous incumbent.

Other elements of remuneration would be in line with the Company's policy set out in the in the future policy.

The maximum variable pay opportunity on recruitment (excluding 'buyouts') would be in line with the future policy table, being a maximum annual bonus award of 100% for Chris Loughlin and 75% for Stephen Bird and Louise Rowe of salary and maximum award under the LTIP of 150% for Chris Loughlin and 80% for Stephen Bird and Louise Rowe of salary.

The Committee may determine for the first year of appointment that any annual bonus will be subject to different weightings or objectives.

To facilitate recruitment it may be necessary to recompense a new Executive Director for the expected value of incentive rewards foregone with their previous employer ('buyout' awards).

Committee may make buyout awards in accordance with LR9.4.2 of the Listing Rules as they apply to Pennon Group. The Committee will ensure that any such award would at a maximum match the value of the awards granted by the previous employer and be made only where a Director is able to demonstrate that a loss has been incurred from leaving his or her previous employment. Any buyout would take into account the terms of the arrangement forfeited, including in particular any performance conditions and the time over which they vest. The award would have time horizons which are in line with or greater than the awards forfeited.

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

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

Non-executive Directors fees would be in line with the policy set out in the future policy table on page 76.

## DATE OF DIRECTORS' SERVICE CONTRACTS/LETTERS OF APPOINTMENT

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

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

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

Non-executive Directors	Date of letter of appointment	Expiry date of appointment
Sir John Parker	19 March 2015	31 March 2018
Martin Angle	1 April 2016	30 November 2017
Neil Cooper	1 April 2016	30 August 2017
Martin Hagen	1 September 2010	31 August 2019
Gill Rider	1 April 2016	30 August 2018
Lord Matthew Taylor	1 March 2010	28 February 2019

The policy is for Executive Directors' service contracts to provide for 12 months' notice from either side.

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

All Non-executive Directors are subject to annual re-election and letters of appointment are for an initial three-year term.

Copies of Executive Directors' service contracts and Non-Executive Directors' letters of appointment are available for inspection at the Company's registered office.

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

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

There are no liquidated damages provisions for compensation on termination within Executive Directors' service agreements. Taking into account the circumstances of any termination, the Committee may determine that a payment in lieu of notice should be made. Any such payments would be restricted to salary and benefits. In these circumstances consideration would be given to phasing of payments and an individual's duty and opportunity to mitigate losses.

The Committee reserves the right to make any other payments in connection with a director's cessation of office or employment where the payments are made in good faith in discharge of an existing legal obligation (or by way of damages for breach of such an obligation) or by way of compromise or settlement of any claim arising in connection with the cessation of a director's office or employment. Any such payments may include but are not limited to paying any fees for outplacement assistance and/or the director's legal and/or professional advice fees in connection with his cessation of office or employment.

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

Any compensation payable will be determined by reference to the terms of the service contract between the Company and the employee, as well as the rules of the various incentive plans as set out in the table below.

<b>Annual bonus</b>	<p>Normally no bonus is payable unless an Executive Director is employed on the date of payment.</p> <p>In certain good leaver circumstances (death, disability, redundancy, retirement and any other circumstance at the Committee's discretion) a bonus may be payable. Any such bonus would be based on performance and pro-rated to reflect the period of service with performance normally assessed at the same time as other employees. The Committee retains discretion to adjust the timing and pro-rating of any award to take account of any prevailing exceptional circumstances which they consider would be fair to the Company and to the employee. Share deferral would not normally apply.</p>
<b>Deferred shares</b>	<p>Unvested awards would normally lapse upon cessation. In certain good leaver circumstances, unless the Committee determines otherwise, the restricted period is not automatically terminated on cessation of employment; rather, the restricted period continues to apply as if the leaver was still in employment. However, awards may be released to participants on cessation of employment at the discretion of the Committee.</p> <p>Good leaver circumstances are death, injury, ill-health, disability, redundancy, retirement, the sale of the individual's employing business or company out of the Pennon Group and any other circumstance at the Committee's discretion.</p>
<b>Long-term incentive plan</b>	<p>Any unvested awards would normally lapse upon cessation of the individual's employment within the Group. In certain good leaver circumstances awards vest to the extent determined by the Committee taking into account the extent to which the performance conditions have been satisfied, the period of time elapsed between grant and the cessation of employment and such other factors as the Committee may deem relevant. Awards would normally vest on the original normal vesting date and be released at the end of the two-year holding period unless the Committee determines awards should be subject to earlier vesting and release dates).</p> <p>If a participant dies, an award will, unless the Committee determines otherwise, vest and be released at the time of the participant's death, taking into account the extent to which the performance conditions have been satisfied and the period of time elapsed since grant.</p> <p>Good leaver circumstances are death, ill health, injury, disability, redundancy, retirement, where the participant's employer is no longer a member of the Pennon Group, where the participant is employed in an undertaking which is transferred out of the Pennon Group, or for any other reason that the Committee determines.</p> <p>All awards would lapse if a participant was summarily dismissed.</p>
<b>All-employee awards</b>	Leavers will be treated in accordance with the HMRC approved rules.
<b>Other awards</b>	Where a buyout award is made recruitment leaver provisions would be determined at the time of award.

#### STATEMENT OF CONSIDERATION OF EMPLOYMENT CONDITIONS ELSEWHERE IN THE COMPANY

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

The Committee does not consult with employees when drawing up the Directors' remuneration policy but does take account of the Group-wide policy as described above.

# ANNUAL REPORT ON REMUNERATION

## INTRODUCTION

This section sets out how the Company has applied its remuneration policy in the 2016/17 year, and details how the new policy will be implemented for the year 2017/18. In accordance with section 439 of the Companies Act, this section will be put to an advisory vote at the Company's AGM which is scheduled to be held on 6 July 2017.

## OPERATION OF THE REMUNERATION POLICY FOR 2017/18

A summary of the specific remuneration arrangements for Executive Directors in 2017/18 is described below:

<b>Base salary</b>	<p>2017/18 salaries are: Chris Loughlin: £517,650<sup>1</sup> Stephen Bird: £243,600 Louise Rowe: £160,000</p> <p>Salaries were increased by 1.5% in line with increases for all employees, except for Louise Rowe who received a 14.3% increase reflecting her performance and experience gained in the role of Finance Director, since her appointment in 2015.</p>													
<b>Pension and benefits</b>	<p>No changes. Salary supplement cash allowance of 30% for Chris Loughlin, 21% for Stephen Bird and 15% for Louise Rowe from which is deducted the employer's contribution to the defined benefit or defined contribution pension schemes for the Directors.</p>													
<b>Annual bonus</b>	<p>No change to maximum opportunity of:</p> <ul style="list-style-type: none"> <li>• Chris Loughlin: 100%<sup>1</sup> of salary</li> <li>• Stephen Bird and Louise Rowe: 75% of salary</li> </ul> <p>No change to operation of deferral with 50% of the bonus to be deferred into shares for three years.</p> <p>For 2017/18, the annual bonus will be based on the following performance measures:</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left;">Chris Loughlin</th> <th style="text-align: left;">Stephen Bird and Louise Rowe</th> <th></th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">60%</td> <td style="text-align: center;">45%</td> <td>based on Pennon Group financial metrics (50% profit before interest and taxation (PBIT), 10% Return on Regulatory Equity (RORE)).</td> </tr> <tr> <td style="text-align: center;">20%</td> <td style="text-align: center;">15%</td> <td>                     based on operational metrics, weighted equally between the waste business and the water business. These measures will be quantitative and measurable, are key to meeting the needs of our customers, our regulator, and wider stakeholders:                     <ul style="list-style-type: none"> <li>• Water metrics:                             <ul style="list-style-type: none"> <li>○ Service Incentive Mechanism (SIM)</li> <li>○ Bathing water quality</li> <li>○ Leakage</li> <li>○ Wastewater pollution incidents</li> <li>○ Duration of interruptions to supply</li> <li>○ Water and wastewater asset reliability</li> </ul> </li> <li>• ERF availability</li> <li>• Delivery against recycling action plan</li> <li>• Growth in customer base</li> </ul> </td> </tr> <tr> <td style="text-align: center;">20%</td> <td style="text-align: center;">15%</td> <td>based on personal strategic measures. These will be relevant to the individual, and will include health and safety and the development of the PR19 business plan, as well as the implementation of specific Group plans and initiatives.</td> </tr> </tbody> </table>		Chris Loughlin	Stephen Bird and Louise Rowe		60%	45%	based on Pennon Group financial metrics (50% profit before interest and taxation (PBIT), 10% Return on Regulatory Equity (RORE)).	20%	15%	based on operational metrics, weighted equally between the waste business and the water business. These measures will be quantitative and measurable, are key to meeting the needs of our customers, our regulator, and wider stakeholders: <ul style="list-style-type: none"> <li>• Water metrics:                             <ul style="list-style-type: none"> <li>○ Service Incentive Mechanism (SIM)</li> <li>○ Bathing water quality</li> <li>○ Leakage</li> <li>○ Wastewater pollution incidents</li> <li>○ Duration of interruptions to supply</li> <li>○ Water and wastewater asset reliability</li> </ul> </li> <li>• ERF availability</li> <li>• Delivery against recycling action plan</li> <li>• Growth in customer base</li> </ul>	20%	15%	based on personal strategic measures. These will be relevant to the individual, and will include health and safety and the development of the PR19 business plan, as well as the implementation of specific Group plans and initiatives.
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	<p>For bonuses from 2014/15 both malus and clawback apply as described in the remuneration policy report.</p>													

<sup>(1)</sup> 50% of Chris Loughlin's remuneration is chargeable to South West Water through Pennon Group recharges, the figure above reflects 100% of his base salary.

OPERATION OF THE REMUNERATION POLICY FOR 2017/18 continued

<b>Long-term incentive plan</b>	Maximum award of 150% for the Pennon Group Chief Executive Officer and 80% of base salary for Stephen Bird and Louise Rowe.									
	For 2017/18, performance measures will be EPS growth and a sustainable dividend measure, and ROCE, with targets set as follows:									
	<b>Pennon Group EPS – 40% weighting</b>									
	<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 60%;"></th> <th style="width: 20%;">EPS growth p.a.</th> <th style="width: 20%;">Vesting</th> </tr> </thead> <tbody> <tr> <td>Threshold</td> <td>6%</td> <td>25%</td> </tr> <tr> <td>Maximum</td> <td>10%</td> <td>100%</td> </tr> </tbody> </table>		EPS growth p.a.	Vesting	Threshold	6%	25%	Maximum	10%	100%
		EPS growth p.a.	Vesting							
	Threshold	6%	25%							
	Maximum	10%	100%							
	Straight line vesting between threshold and maximum									
	<b>Sustainable dividend measure (dividend growth and dividend cover) – 40% weighting</b> The performance measure comprises two performance targets, both of which need to be achieved. There is a “gateway” dividend growth target of RPI+4% per annum. There is then an EBITDA dividend cover target which operates as follows:									
	<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 60%;"></th> <th style="width: 20%;">EBITDA dividend cover</th> <th style="width: 20%;">Vesting</th> </tr> </thead> <tbody> <tr> <td>Threshold</td> <td>2.6</td> <td>25%</td> </tr> <tr> <td>Maximum</td> <td>3.6</td> <td>100%</td> </tr> </tbody> </table>		EBITDA dividend cover	Vesting	Threshold	2.6	25%	Maximum	3.6	100%
		EBITDA dividend cover	Vesting							
	Threshold	2.6	25%							
	Maximum	3.6	100%							
	Straight line vesting between threshold and maximum									
	As an additional underpin the board must also be satisfied with the level of EPS dividend cover. EBITDA dividend cover will be based on adjusted EBITDA calculated as (underlying EBITDA + share of JV dividends & interest receivable + IFRIC12 interest receivable).									
For the purpose of the calculation, dividend cover would be based on the policy of 4% p.a. above RPI.										
<b>Return on capital employed (ROCE)* – 20% weighting</b>										
<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 60%;"></th> <th style="width: 20%;">Average ROCE</th> <th style="width: 20%;">Vesting</th> </tr> </thead> <tbody> <tr> <td>Threshold</td> <td>8%</td> <td>25%</td> </tr> <tr> <td>Maximum</td> <td>10%</td> <td>100%</td> </tr> </tbody> </table>		Average ROCE	Vesting	Threshold	8%	25%	Maximum	10%	100%	
	Average ROCE	Vesting								
Threshold	8%	25%								
Maximum	10%	100%								
ROCE is defined as (operating profit + JV profit after tax + interest receivable) divided by capital employed (debt + equity including hybrid).										
Straight line vesting between threshold and maximum										
The LTIP award will be subject to an ‘underpin’ relating to overall Group performance including consideration of environmental, social and governance factors and safety performance, as well as financial performance.										
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 remuneration policy report.										
Performance is measured over three years and a two-year holding period applies.										
<b>Shareholding guidelines</b>	200% of salary for Chris Loughlin, the Pennon Group Chief Executive Officer and 100% of salary for the South West Water Managing Director and South West Water Finance Director.									

## NON-EXECUTIVE DIRECTOR FEES

Non-executive Director fees for 2017/18 are set out below. They include an 1.5% increase for the Chairman and joint Pennon Non-executive Directors and 10% for South West Water only Non-executive Directors reflecting increases in responsibility in the year, approved by the Board.

Director	Fees £000
Sir John Parker	270
Martin Angle	67
Neil Cooper	66
Martin Hagen	55
Gill Rider	74
Lord Matthew Taylor	55

The Chairman, Sir John Parker, and Martin Angle, Neil Cooper and Gill Rider's Non-executive Director fees are set by Pennon Group Plc and 50% of these fees are charged to South West Water through group recharges.

The table above outlines the full fees 2017/18.

## SINGLE TOTAL FIGURE OF REMUNERATION TABLES (AUDITED INFORMATION)

	Base salary/fees (£000)		Benefits <sup>(1)</sup> (including sharesave) (£000)		Annual bonus (cash bonus and deferred shares) (£000)		Performance and co-investment plan (£000)		Pension <sup>(3)</sup> (£000)		Total remuneration (£000)	
	2016 /17	2015 /16	2016 /17	2015 /16	2016 /17	2015 /16	2016 /17 <sup>(2)</sup>	2015 /16	2016 /17	2015 /16	2016 /17	2015 /16
<b>Executive Directors</b>												
Chris Loughlin, Pennon Chief Executive Office	255	304	13	21	215	257	100	88	77	91	660	761
Stephen Bird, Managing Director	240	199	20	18	158	117	71	64	64	63	553	461
Louise Rowe, Finance Director	140	115	10	9	96	71	-	-	22	16	268	211
<b>Non-Executive Directors</b>												
Sir John Parker, Chairman	133	110	-	-	-	-	-	-	-	-	133	110
Martin Angle	33	-	-	-	-	-	-	-	-	-	33	-
Neil Cooper	33	-	-	-	-	-	-	-	-	-	33	-
Martin Hagen	50	45	-	-	-	-	-	-	-	-	50	-
Gill Rider	36	-	-	-	-	-	-	-	-	-	36	-
Lord Matthew Taylor	50	45	-	-	-	-	-	-	-	-	50	45
D Ingram	4	45	-	-	-	-	-	-	-	-	4	45
S Johnson	8	45	-	-	-	-	-	-	-	-	8	45

(1) Benefits comprise a car allowance and medical insurance

(2) Based on an estimated 43.7% vesting as referred to on page 91 and based on the Company's share price of 836.64p (being the average share price over the fourth quarter (Q4) of 2016/17), together with an estimate of the accrued dividends payable on the vesting shares

(3) See page 87 for further information.

## ANNUAL BONUS OUTTURN FOR 2016/17 (AUDITED INFORMATION)

The performance targets set and the performance achieved in respect of the annual bonus for 2016/17 in respect of each Executive Director is set out below.

### Chris Loughlin

Chris Loughlin is also Pennon Group Chief Executive Officer and therefore his objectives reflect Pennon Group targets and objectives.

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
<b>Pennon Group EPS (30% weighting)</b>						24.83%
		37.53p	41.7p	47.96p	47.0p	
<b>Average South West Water directors' performance (20% weighting)</b> The average of the bonus earned by the executive directors of South West Water in respect of the targets which related to:						17.56%
Operating profit		£224.6m	£229.2m	£233.8m	£234.3m	
Return on regulated equity		7.0%	9.0%	11%	12.6%	
Net debt*						
Totex outperformance*						
The achievement of a range of service improvements relating to bathing water quality, SIM, leakage, wastewater compliance, pollutions, resolution of operational contacts, duration of supply interruptions, asset reliability and employee engagement.						
<b>Average Viridor directors' performance (20% weighting)</b> The average of the bonus earned by the executive directors of Viridor in respect of the targets which related to:						14.82%
EBITDA + JVs		£119.6m	£132.9m	£146.2m	£142.5m	
Budgeted restructuring savings		£56.1m	£59.0m	£62.0m	£58.7m	
Sales revenue		£731.9m	£770.4m	£808.9m	£785.0m	
Environmental compliance events		-	11	-	3	
<b>Personal strategic objectives (30% weighting)*</b>						26.84%
<ul style="list-style-type: none"> <li>• Successful implementation of new governance arrangement across the Group to ensure these are effective and efficient, with improved processes, communications and development of common services and synergies</li> <li>• Refreshment of group strategy, including identification of focus and growth areas, as well as agreement of appropriate business model for waste recycling. Establishment of 'Growth Forum' to consider and validate growth opportunities. Centralisation of the recycling business model. Implementation of 'self help' measures for margin (Viridor has improved from 3.2% to 4.7%) and ROCE improvement</li> <li>• Revision of succession planning process and structure for directors</li> <li>• Enhancement of Pennon's recognition, branding and reputation with internal and external stakeholders. Completion of a group wide rebranding exercise, which following board approval was rolled out throughout the organisation. Results of investor surveys on Pennon brand recognition at investor level</li> <li>• Delivery of strategic priorities around Group level processes, synergies and efficiencies. Achievement of £100m EBITDA target for ERF, with improvement in recycling margins. Strong progression of Shared Services and establishment of a Group executive.</li> </ul>						
<b>Total outturn</b>						<b>84.05%</b>

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

Stephen Bird, Louise Rowe

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
<b>Average South West Water directors' performance (45% weighting)</b>						39.5%
The average of the bonus earned by the executive directors of South West Water in respect of the targets which related to:						
Operating profit		£224.6m	£229.2m	£233.8m	£234.3m	
Return on regulated equity		7.0%	9.0%	11%	12.6%	
Net debt*						
Totex outperformance*						
The achievement of a range of service improvements relating to bathing water quality, SIM, leakage, wastewater compliance, pollutions, resolution of operational contacts, duration of supply interruptions, asset reliability and employee engagement.						
<b>Personal strategic objectives (30% weighting)*</b>						S Bird 26.3% L Rowe 29.0%
Including South West Water's new strategies and projects including the achievement of the transition milestones and synergies related to the Bournemouth Water acquisitions and the delivery of opex/capex efficiency targets.*						
<b>Total outturn</b>						<b>S Bird 65.8% L Rowe 68.5%</b>

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

## PERFORMANCE & CO-INVESTMENT PLAN OUTTURN FOR 2016/17

The PCP awards made on 14 July 2014, which are due to vest on 14 July 2017, are the awards included in the single figure table and currently it is estimated that the outturn will result in a 43.7% vesting as set out in the table below.

The extent to which the awards will vest is subject to the satisfaction of the performance conditions that were in place at the time the awards were made:

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 | • S  ch   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).

Currently it is estimated that the outturn will result in a 43.7% vesting as set out in the table below.

The calculation of Pennon Group's TSR performance from the start of the performance period on 1 April 2013 to 10 May 2017 was undertaken by Deloitte LLP.

	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	4.87% above the index	26.4%
FTSE 250 (excluding investment trusts) (50% of award)	Above 50th percentile	At or above 75th percentile	52.0%	17.3%
<b>TOTAL</b>				<b>43.7%</b>

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 2017 to 30 June 2017) the achievement and the outturn is an estimate at the date of calculation 18 May 2017.

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.

## RETIREMENT BENEFITS AND ENTITLEMENTS (AUDITED INFORMATION)

Stephen Bird was a 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 83.

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

	Value of defined benefit pension(i) (£000)	Contributions to defined contribution arrangements (£000)	Cash allowances in lieu of pension (£000)	Total value for the year	Normal retirement age and date (for pension purposes)	Accrued pension at 31 March 2017 (£000)
Chris Loughlin	-	-	77 <sup>(iii)</sup>	77	67 (20 August 2019)	-
Stephen Bird	36	-	29	-	60 (14 May 2018)	101
Louise Rowe	-	13 <sup>(ii)</sup>	9 <sup>(ii)</sup>	22	65 (15 January 2047)	-

- (i) The value of the defined benefit pension accrued over the period comprises the total pension input amount (which has been calculated in line with regulatory requirements) less the pension contributions paid by the Director
- (ii) 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.
- (iii) 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. 50% of this charge is recharged to South West Water through group recharges, and reflected in the table above.

No additional benefits will become receivable by a Director in the event that the Director retires early.

### Board changes

From 1 April 2016 existing Pennon Group Non-executive Directors (Martin Angle, Neil Cooper and Gill Rider) 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 external executive appointment.

### 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.

### Non-executive Director fees and benefits

The Non-Executive Directors' fees were increased for 2016/17 by amounts ranging from 0.6% to 7.3%, to reflect principally changed responsibilities and additional commitments arising from the revised Board governance structure. The Chairman's increase was 1.5%.

The Chairman's benefits comprise provision of a driver and vehicle, when appropriate for the efficient carrying out of his duties. He is entitled to expenses on the same basis as for the other Non-executive Directors.

## ALL EMPLOYEE, PERFORMANCE AND OTHER CONTEXTUAL INFORMATION

### Remuneration of the Managing Director

	2013/14	2014/15	2015/16 <sup>(1)</sup>	2016/17 <sup>(1)</sup>
Managing Director single figure remuneration	408	378	461	553
Annual Bonus payout (% of maximum)	84.8%	89.6%	78.3%	65.8%
LTIP (PCP) vesting (% of maximum)	30.2%	0.0%	34.5%	43.7%

<sup>1</sup> For 2015/16 and 2016/17 this reflects the remuneration of Chris Loughlin as paid by or chargeable to South West Water, following his appointment as Pennon Group Chief Executive.

### COMPARISON OF MANAGING DIRECTOR REMUNERATION TO EMPLOYEE REMUNERATION

The table below shows the percentage change between 2015/16 and 2016/17 in base salary, benefits and annual bonus for the average of the Managing Director and all employees.

The percentage increase in salary for employees reflects the annual award for staff in 2016/17 of 1.5%, analysed into the three components in the table below.

	Percentage change in salary	Percentage change in benefits	Percentage change in annual bonus
Managing Director remuneration	1.5%	11.1%	35%
All employees	1.5%	-	15%

The increase in the Managing Director remuneration reflects the appointment into the role at the end of 2015/16 having previously held the role of Operations Director.

### RELATIVE IMPORTANCE OF SPEND ON PAY

	2016/17 (£m)	2015/16 (£m)	Percentage change (%)
Overall expenditure on pay <sup>1</sup>	54.1	47.3	12.6
Distributions to Parent Company	213.1	74.9	184.5
Net interest charges	61.9	55.3	11.7
Purchase of property, plant and equipment (cash flow)	183.3	119.1	53.9

<sup>1</sup> 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. 2016/17 reflects the expenditure of both the South West Water and Bournemouth Water regions.

## 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	510	30% of maximum	31 March 2019
Stephen Bird		80 % of salary	192		
Louise Rowe			112		
Chris Loughlin	Deferred bonus / ESOS	50% of bonus awarded	178	n/a	4 July 2019
Stephen Bird			56		
Louise Rowe			36		

PCP awards were calculated using the share price at close on 29 June 2016, which was £9.20 per share. The date of grant was 1 July 2016. Deferred bonus awards were calculated using the share price at which shares were purchased on the market on 1 July 2016 in order to satisfy the award, which was 950.14p.

Sharesave (SAYE) awards were also made, as detailed on page 93.

#### 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 Pennon Group Plc shareholders.

To support this, the Committee operates shareholding guidelines. For 2016/17, this guideline was 100% of salary for Executive Directors. From 2017/18 the Committee has significantly increased these guidelines to 200% of salary for the Pennon Group Chief Executive Officer and remains 100% of salary for Stephen Bird and Louise Rowe. The Executive Directors are expected to build up a shareholding in the Company within the first five years of joining the Company.

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 2017 (or date of cessation, if earlier) and 31 March 2016 together with their shareholding guideline obligation (based on the 2016/17 guideline of 100% of salary) and interest are shown in the table below:

	Share interests (including connected parties) at 31 March 2017	Share interests (including connected parties) at 31 March 2016	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	290,323	247,745	100%	Yes	153,251	4,984	57,435	-
Stephen Bird	25,500	20,370	100%	Yes	56,391	2,646	20,416	-
Louise Rowe	5,134	4,420	40%	Yes	23,524	2,789	5,547	1,553

Since 31 March 2017 4,858 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 100 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 2017	Shares held at 31 March 2016
Sir John Parker, Chairman	10,000	10,000
Martin Angle	-	-
Neil Cooper	-	-
Martin Hagen	3,600	3,600
Sir John Parker	-	-
Lord Matthew Taylor	-	-
Gill Rider	2,500	2,500

Since 31 March 2017 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 2016	Conditional awards made in year	Market price upon award in year	Vesting in year <sup>(1)</sup>	Value of shares upon vesting (before tax) £000	Conditional awards held at 31 March 2017	Date of end of period for qualifying conditions to be fulfilled
<b>Chris Loughlin</b>							
2/7/13	57,810	-	653.00p	24,625	224	-	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
1/7/16	-	55,434	920.00p	-	-	55,434	30/6/19
<b>Stephen Bird</b>							
2/7/13	20,594	-	653.00p	8,772	80	-	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
1/7/16	-	20,869	920.00p	-	-	20,869	30/6/19
<b>Louise Rowe</b>							
1/7/15	11,351	-	810.50p	-	-	11,351	30/6/18
1/7/16	-	12,173	920.00p	-	-	12,173	30/6/19

**(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 2016	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 2017	Date of end of period for qualifying conditions to be fulfilled
<b>Chris Loughlin</b>							
5/8/13 <sup>1</sup>	16,978	-	693.00p	16,040	141	-	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
4/7/16	-	18,759	950.14p	-	-	18,759	3/7/19
<b>Stephen Bird</b>							
5/8/13 <sup>1</sup>	7,052	-	693.00p	7,052	62	-	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
4/7/16	-	6,589	950.14p	-	-	6,589	3/7/19
<b>Louise Rowe</b>							
27/7/15 <sup>1</sup>	1,553	-	791.00p	-	-	1,553	26/7/18
4/7/16	-	3,994	950.14p	-	-	3,994	3/7/19

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 84.

During the year the Directors received dividends on the above shares in accordance with the conditions of the bonus plan as follows: Chris Loughlin £23,026\*; Stephen Bird £8,535; Louise Rowe £1,444.

- \* Chris Loughlin received his 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 2017 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 2016	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 2017	Options held at 31 March 2017	Maturity date
C. Loughlin 5/8/13	4,329	-	4,329	693.00p	884.5p	-	-	-
S. Bird 5/8/13	4,329	-	-	-	-	-	-	-
L. Rowe 27/7/15	1,553	-	-	791.00p	-	-	1,553	27/7/18

**(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 2016	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 2017	Options held at 31 March 2017	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	1/9/20- 28/2/21
S. Bird 3/7/13	501	-	(501)	538.00p	-	-	-	1/9/16- 28/2/17
14/7/14	441	-	-	611.00p	-	811.00p	441	1/9/17- 28/2/18
24/6/15	1,317	-	-	683.00p	-	811.00p	1,317	1/9/18- 28/2/19
29/6/16	-	888	-	709.00p	-	811.00p	888	1/9/19 – 2/2/20
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

## BOARD OF DIRECTORS AND COMPANY INFORMATION

<b>CHAIRMAN</b>	Sir John Parker
<b>PENNON GROUP CHIEF EXECUTIVE</b>	C Loughlin
<b>MANAGING DIRECTOR</b>	Dr S C Bird
<b>FINANCE DIRECTOR</b>	L F Rowe
<b>NON-EXECUTIVE DIRECTORS</b>	M Angle (appointed 1 April 2016) N Cooper (appointed 1 April 2016) M J Hagen G Rider (appointed 1 April 2016) Lord Taylor of Goss Moor
<b>COMPANY SECRETARIES</b>	H Barrett-Hague K Senior R C Zmuda (resigned 30 November 2016)
<b>REGISTERED OFFICE</b>	Peninsula House Rydon Lane Exeter Devon EX2 7HR
<b>INDEPENDENT AUDITOR</b>	Ernst & Young LLP Apex Plaza Forbury Road Reading RG1 1YE
<b>COMPANY'S REGISTERED NUMBER</b>	02366665
<b>PRINCIPAL ACTIVITIES</b>	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 three pages and the following matters disclosed elsewhere in this Annual Report as follows:

- list of Directors during the year as set out on page 94
- risk management objectives and policies (page 25)
- likely future developments of the Company (outlook sections of the strategic report)
- inclusion and gender diversity (page 58 of the corporate governance report)
- statement of Directors' responsibilities in respect of the annual report and the financial statements (pages 98 to 99)
- financial instruments (page 118 of the financial statements).

## FINANCIAL RESULTS AND DIVIDEND

A total dividend for the year of £213.1m was paid during the year (2015/16: £74.9m). The 'Finance and Economy' section of the strategic report on pages 16 to 21 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 94. Further details relating to the Directors and their service agreements or contracts for services are set out on page 79 and details of the Directors' interests in shares of Pennon Group Plc are given on pages 89 to 93.

## 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 58.

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 14 to 15.

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 has published an anti-slavery and human trafficking statement covering operations across the group. This is available at the South West Water homepage:

[www.southwestwater.co.uk](http://www.southwestwater.co.uk)

## **POLITICAL DONATIONS**

No political donations were made or political expenditure incurred and no contributions were made to a non-EU political party (2015/16: nil).

## **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 6 July 2017 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 2017.

### **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



K SENIOR  
Secretary  
Peninsula House  
Rydon Lane  
Exeter  
Devon  
EX2 7HR

30 May 2017

# 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



K SENIOR  
Secretary  
Peninsula House  
Rydon Lane  
Exeter  
Devon  
EX2 7HR

30 May 2017

# 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 2017 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;
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

## WHAT WE HAVE AUDITED

South West Water Limited's financial statements comprise:

- Income statement
- Statement of comprehensive income
- Balance sheet
- Statement of changes in equity
- Cash flow statement
- Related notes 1 to 37 to the financial statements

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 and as applied in accordance with the provisions of the Companies Act 2006.

## OVERVIEW OF OUR AUDIT APPROACH

Risks of material misstatement	<ul style="list-style-type: none"><li>• Revenue recognition across the Company's operations</li><li>• Valuation of the provision for doubtful debts</li><li>• Valuation of property, plant and equipment</li></ul>
Audit scope	<ul style="list-style-type: none"><li>• We performed an audit of the complete financial information of the Company</li></ul>
Materiality	<ul style="list-style-type: none"><li>• Overall materiality of £8.7m which represents approximately 5% of profit before taxation before non-underlying items</li></ul>

## OUR ASSESSMENT OF RISKS OF MATERIAL MISSTATEMENT

We identified the risks of material misstatement described below as those that had the greatest effect on our 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.

Risk	Risk direction	Our response to the risk	What we concluded to the Audit Committee
<p><b>Revenue recognition across the Company's operations</b></p> <p><i>Refer to the Audit Committee Report (page 48); Accounting policies (page 112); and Note 4 of the Financial Statements (page 119)</i></p> <p>The Company's material revenue streams relate to the provision of water and sewerage services. ISAs (UK &amp; Ireland) presume there is a risk of fraud relating to revenue recognition. For the Company, given targets associated to financial performance and pressures to meet market expectations, there is an incentive to overstate revenue. 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"> <li>▶ 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 2017 is £77.7 million (2016: £67.8 million).</li> <li>▶ For unmeasured revenue, the bills for each calendar year are raised in advance for the next financial year. 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.</li> </ul>		<p>Our procedures include:</p> <ul style="list-style-type: none"> <li>▶ 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.</li> <li>▶ We tested key controls linked to system generated information relating to the estimation process for measured revenue.</li> <li>▶ 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.</li> <li>▶ We performed a walkthrough of the process for unmeasured revenue and the annual billing cycle.</li> <li>▶ We performed controls testing related to the calculation of system generated billing for unmeasured revenue.</li> <li>▶ We obtained details of the billing runs in February and March and assessed whether there were any other billing runs for unmeasured revenue that should be excluded from 2016/17 total revenue.</li> <li>▶ 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.</li> <li>▶ We tested whether revenue was recognised at the correct time in accordance with IFRS.</li> <li>▶ We performed analytical procedures by comparing revenue balances for the year against expectation and obtaining support for significant variances.</li> <li>▶ We tested a sample of transactions to underlying bills for both types of revenue.</li> <li>▶ In performing our journal testing, we paid increased attention to entries impacting revenue focusing on non-system postings and those raised in the last two weeks of the year.</li> </ul>	<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>

Risk	Risk direction	Our response to the risk	What we concluded to the Audit Committee
<p><b>Valuation of the provision for doubtful debts</b></p> <p><i>Refer to the Audit Committee Report (page 48); Accounting policies (page 115); and Note 4 of the Financial Statements (page 119)</i></p> <p>As shown in note 18, there is a provision of £91.4 million (2016: £88.7 million) at the year end against gross amounts receivable from customers of £210.4 million (2016: £191.8 million).</p> <p>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.</p> <p>During the year management has performed a data mining exercise to refresh the detailed collection data by category of debt.</p> <p>There is a risk that the assumptions used by management in calculating the bad debt provision may be susceptible to management bias and the valuation of the provision against trade receivables may be misstated.</p>		<p>Our procedures include:</p> <ul style="list-style-type: none"> <li>▶ We performed a walkthrough of the process for calculating the bad debt provision and assessed the design effectiveness of key controls.</li> <li>▶ We tested the operating effectiveness of key controls over the integrity of data and the report utilised to generate the ageing and categorisation of debt within the Company's billing system.</li> <li>▶ We tested historic data on collection rates and evaluated how this data was used in the preparation of the bad debt provision.</li> <li>▶ 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.</li> <li>▶ 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, including assessing assumptions for evidence of management bias.</li> <li>▶ We tested the appropriateness of journal entries and adjustments impacting the doubtful debt provision in the particularly those raised close to the balance sheet date.</li> </ul>	<p>We concluded that the doubtful debt provision is within an acceptable range and reflects recent history of collection of outstanding debts.</p>
<p><b>Valuation of property, plant and equipment</b></p> <p><i>Refer to Accounting policies (page 113); and Note 4 of the Financial Statements (page 120)</i></p> <p>As shown in note 14, the carrying value of the Company's property, plant and equipment totals £2,899.8 million (2016: £2,659.9 million).</p> <p>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.</p>		<p>Our procedures include:</p> <ul style="list-style-type: none"> <li>▶ 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'.</li> <li>▶ We tested the asset lives utilised based on latest third party benchmarking.</li> <li>▶ We re-performed the calculation of depreciation.</li> <li>▶ 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.</li> </ul>	<p>We concluded that fixed assets have been correctly accounted for in the financial statements.</p>

## 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

With effect from 1 April 2016, the operations and licence of Bournemouth Water were merged with South West Water and therefore these financial statements include the results, assets and liabilities of the combined activities throughout the year ended 31 March 2017 and have been included in all our audit procedures.

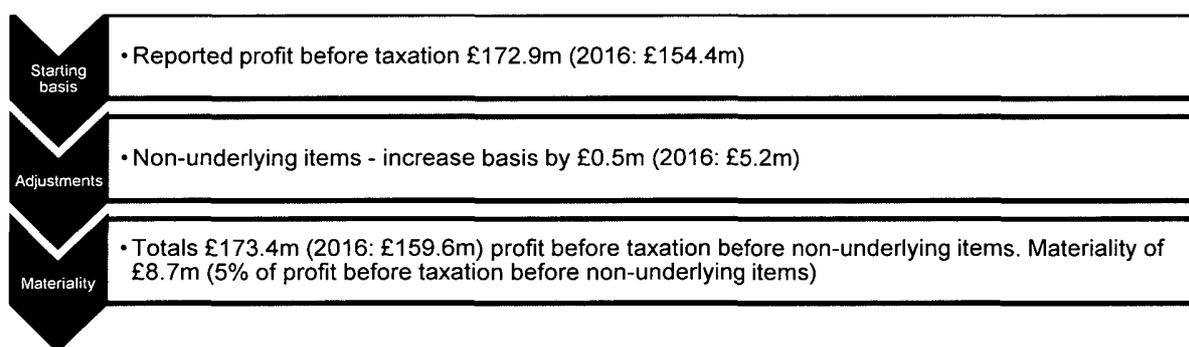
### OUR APPLICATION OF MATERIALITY

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 £8.7 million (2016: £8 million), which is 5% (2016: 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% (2016: 75%) of our planning materiality, namely £6.5 million (2016: £6 million). This is based on our assessment of the Company's internal control environment and the extent and nature of audit findings identified in the prior period and is consistent with the prior year.

## 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 million (2016: £0.4 million), 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 98 to 99, 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 95, and longer-term viability, set out on page 29; 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 based on the work undertaken in the course of the audit:

- the information given the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements;
- the Strategic Report and the Directors' Report have been prepared in accordance with the applicable legal requirements.

**MATTERS ON WHICH WE ARE REQUIRED TO REPORT BY EXCEPTION**

<p><b>ISAs (UK and Ireland) reporting</b></p>	<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"> <li>• materially inconsistent with the information in the audited financial statements; or</li> <li>• apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Company acquired in the course of performing our audit; or</li> <li>• otherwise misleading.</li> </ul>	<p>We have no exceptions to report.</p>
<p><b>Companies Act 2006 reporting</b></p>	<p>In light of the knowledge and understanding of the Company and its environment obtained in the course of the audit, we have identified no material misstatements in the Strategic Report or Directors' Report.</p> <p>We are required to report to you if, in our opinion:</p> <ul style="list-style-type: none"> <li>• 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</li> <li>• the financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or</li> <li>• certain disclosures of directors' remuneration specified by law are not made; or</li> <li>• we have not received all the information and explanations we require for our audit.</li> </ul>	<p>We have no exceptions to report.</p>

<p><b>The terms of our engagement letter</b></p>	<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"> <li>• materially inconsistent with the information in the audited financial statements; or</li> <li>• apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Company acquired in the course of performing our audit; or</li> <li>• is otherwise misleading.</li> </ul> <p>In particular, we are required to report whether we have identified any inconsistencies between our knowledge acquired in the course of performing the audit and the directors' statement that they consider the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the entity's performance, business model and strategy; and whether the annual report appropriately addresses those matters that we communicated to the audit committee that 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"> <li>• the directors' statement in relation to going concern, set out on page 95, and longer-term viability, set out on page 29; and</li> <li>• 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.</li> </ul>	<p>We have no exceptions to report.</p>
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**STATEMENT ON THE DIRECTORS' ASSESSMENT OF THE PRINCIPAL RISKS THAT WOULD THREATEN THE SOLVENCY OR LIQUIDITY OF THE ENTITY**

<p><b>The terms of our engagement letter</b></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, we 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"> <li>• 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;</li> <li>• the disclosures in the annual report that describe those risks and explain how they are being managed or mitigated;</li> <li>• 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</li> <li>• 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.</li> </ul>	<p>We have nothing material to add or to draw attention to.</p>
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*Ernst & Young LLP*

DEBBIE O'HANLON (Senior statutory auditor)  
for and on behalf of Ernst & Young LLP, Statutory Auditor  
Reading  
30 May 2017

**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 2017

	Notes	Before non-underlying items 2017 £m	Non-underlying items (note 5) 2017 £m	Total 2017 £m	Before non-underlying items 2016 £m	Non-underlying items (note 5) 2016 £m	Total 2016 £m
Revenue		562.5	-	562.5	506.4	-	506.4
Operating costs	6						
Employment costs		(46.7)	(0.5)	(47.2)	(40.3)	(4.7)	(45.0)
Raw materials and consumables used		(19.2)	-	(19.2)	(15.7)	-	(15.7)
Other operating expenses		(148.0)	-	(148.0)	(132.6)	(0.5)	(133.1)
<b>Earnings before interest, tax, depreciation and amortisation</b>		<b>348.6</b>	<b>(0.5)</b>	<b>348.1</b>	<b>317.8</b>	<b>(5.2)</b>	<b>312.6</b>
Depreciation and amortisation		(113.8)	-	(113.8)	(102.8)	-	(102.8)
<b>Operating profit</b>		<b>234.8</b>	<b>(0.5)</b>	<b>234.3</b>	<b>215.0</b>	<b>(5.2)</b>	<b>209.8</b>
Finance income	7	1.5	-	1.5	2.8	-	2.8
Finance costs	7	(62.9)	-	(62.9)	(58.2)	-	(58.2)
<b>Net finance costs</b>		<b>(61.4)</b>	<b>-</b>	<b>(61.4)</b>	<b>(55.4)</b>	<b>-</b>	<b>(55.4)</b>
<b>Profit before tax</b>		<b>173.4</b>	<b>(0.5)</b>	<b>172.9</b>	<b>159.6</b>	<b>(5.2)</b>	<b>154.4</b>
Taxation credit / (charge)	8	(37.1)	14.4	(22.7)	(22.2)	27.8	5.6
<b>Profit for the year</b>		<b>136.3</b>	<b>13.9</b>	<b>150.2</b>	<b>137.4</b>	<b>22.6</b>	<b>160.0</b>

# STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 MARCH 2017

	Notes	Before non-underlying items 2017 £m	Non-underlying items (note 5) 2017 £m	Total 2017 £m	Before non-underlying items 2016 £m	Non-underlying items (note 5) 2016 £m	Total 2016 £m
<b>Profit for the year</b>		<b>136.3</b>	<b>13.9</b>	<b>150.2</b>	<b>137.4</b>	<b>22.6</b>	<b>160.0</b>
<b>Other comprehensive (loss)/income</b>							
<b>Items which will not be reclassified to profit or loss</b>							
Remeasurement of defined benefit obligations	24	(7.7)	-	(7.7)	(3.6)	-	(3.6)
Income tax on items that will not be reclassified	25	1.4	(0.4)	1.0	0.7	(2.1)	(1.4)
<b>Total items that will not be reclassified to profit or loss</b>		<b>(6.3)</b>	<b>(0.4)</b>	<b>(6.7)</b>	<b>(2.9)</b>	<b>(2.1)</b>	<b>(5.0)</b>
<b>Items that may be reclassified subsequently to profit or loss</b>							
Cash flow hedges		5.1	-	5.1	(7.1)	-	(7.1)
Income tax on items that may be reclassified	25	(0.5)	(0.4)	(0.9)	1.4	(0.8)	0.6
<b>Total items that may be reclassified subsequently to profit or loss</b>		<b>4.6</b>	<b>(0.4)</b>	<b>4.2</b>	<b>(5.7)</b>	<b>(0.8)</b>	<b>(6.5)</b>
<b>Other comprehensive loss for the year net of tax</b>		<b>(1.7)</b>	<b>(0.8)</b>	<b>(2.5)</b>	<b>(8.6)</b>	<b>(2.9)</b>	<b>(11.5)</b>
<b>Total comprehensive income for the year</b>		<b>134.6</b>	<b>13.1</b>	<b>147.7</b>	<b>128.8</b>	<b>19.7</b>	<b>148.5</b>

The notes on pages 112 to 142 form part of these financial statements.

# BALANCE SHEET

AS AT 31 MARCH 2017

	Notes	2017 £m	2016 £m
<b>Assets</b>			
<b>Non-current assets</b>			
Goodwill	12	51.3	-
Other intangible assets	13	1.5	-
Property, plant and equipment	14	2,899.8	2,659.9
Investment in subsidiary undertakings	16	3.3	3.3
		<b>2,955.9</b>	<b>2,663.2</b>
<b>Current assets</b>			
Inventories	17	5.3	5.5
Trade and other receivables	18	142.2	117.4
Cash and cash deposits	20	247.4	251.2
		<b>394.9</b>	<b>374.1</b>
<b>Liabilities</b>			
<b>Current liabilities</b>			
Borrowings	22	(158.3)	(104.6)
Derivative financial instruments	19	(15.2)	(14.4)
Trade and other payables	21	(93.5)	(79.3)
Current tax liabilities		(12.2)	(10.8)
Provisions	26	(4.9)	(6.7)
		<b>(284.1)</b>	<b>(215.8)</b>
<b>Net current assets</b>		<b>110.8</b>	<b>158.3</b>
<b>Non-current liabilities</b>			
Borrowings	22	(2,122.9)	(1,939.9)
Other non-current liabilities	23	(102.4)	(80.5)
Derivative financial instruments	19	(23.9)	(29.3)
Retirement benefit obligations	24	(32.3)	(29.6)
Deferred tax liabilities	25	(220.0)	(211.8)
		<b>(2,501.5)</b>	<b>(2,291.1)</b>
<b>Net assets</b>		<b>565.2</b>	<b>530.4</b>
<b>Equity</b>			
Called up share capital	27	250.9	150.9
Retained earnings and other reserves	29	314.3	379.5
<b>Total Equity</b>		<b>565.2</b>	<b>530.4</b>

The notes on pages 112 to 142 form part of these financial statements.

The financial statements on pages 108 to 142 were approved and authorised for issue by the Board of Directors on 30 May 2017 and were signed on its behalf by:



**Dr 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 2017

	Called up share capital (note 27) £m	Retained earnings and other reserves (note 29) £m	Total Equity £m
<b>At 31 March 2015</b>	<b>150.9</b>	<b>305.4</b>	<b>456.3</b>
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)
<b>At 31 March 2016</b>	<b>150.9</b>	<b>379.5</b>	<b>530.4</b>
Called up Share Capital	100.0	-	100.0
Profit for the year	-	150.2	150.2
Other comprehensive loss for the year	-	(2.5)	(2.5)
Total comprehensive income for the year	-	147.7	147.7
<i>Transactions with owners</i>			
Dividends paid	-	(213.1)	(213.1)
Share based payments (net of tax)	-	0.2	0.2
Total transactions with owners	-	(212.9)	(212.9)
<b>At 31 March 2017</b>	<b>250.9</b>	<b>314.3</b>	<b>565.2</b>

The notes on pages 112 to 142 form part of these financial statements.

# CASH FLOW STATEMENT

## FOR THE YEAR ENDED 31 MARCH 2017

	Notes	2017 £m	2016 £m
<b>Cash flows from operating activities</b>			
Cash generated from operations	30	330.7	298.5
Interest paid		(47.0)	(49.6)
Tax paid		(31.6)	(32.4)
<b>Net cash generated from operating activities</b>		<b>252.1</b>	<b>216.5</b>
<b>Cash flows from investing activities</b>			
Interest received		0.6	0.4
Acquisition of subsidiaries (net of cash acquired)	16	8.3	-
Loss from sale of intangibles		(0.3)	-
Purchase of property, plant and equipment		(183.3)	(119.1)
Receipt of grants and contributions		1.9	5.3
Proceeds from sale of property, plant and equipment		2.4	1.7
<b>Net cash used in investing activities</b>		<b>(170.4)</b>	<b>(111.7)</b>
<b>Cash flows from financing activities</b>			
Deposit of restricted funds		(6.5)	(16.8)
Proceeds from new borrowing		130.0	80.0
Repayment of borrowings		(38.7)	(31.1)
Proceeds/ (repayments) from intercompany borrowings		50.0	(80.0)
Finance lease sale and lease back		0.6	31.0
Finance lease principal repayments		(15.5)	(27.7)
Dividends paid		(213.1)	(74.9)
<b>Net cash used in financing activities</b>		<b>(93.2)</b>	<b>(119.5)</b>
<b>Net decrease in cash and cash equivalents</b>		<b>(11.5)</b>	<b>(14.7)</b>
<b>Cash and cash equivalents at beginning of the year</b>		<b>37.2</b>	<b>51.9</b>
<b>Cash and cash equivalents at end of the year</b>	20	<b>25.7</b>	<b>37.2</b>

The notes on pages 112 to 142 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 94. The nature of the Company's operations and its principal activities are set out on page 94.

## 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 (u) and (n) 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 95.

The new standards or interpretations which were mandatory for the first time in the year beginning 1 April 2016 did not have a material impact on the net assets or results of the Company.

It is anticipated that adoption of the following standard could impact the Company's future results as set out below:

- 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 affect primarily the accounting for the Company's operating leases. As at the reporting date, the Company has non-cancellable operating lease commitments of £56m, see note 32. The Company is assessing the extent to which these commitments will result in the recognition of an asset and a liability for future payments and how this will affect the group's profit and classification of cash flows. Existing borrowing covenants are not impacted by changes in accounting standards.

Other new standards or interpretations in issue, but not yet effective, including IFRS 15 'Revenue from contracts with customers' and IFRS 9 'Financial instruments' are not expected to have a material impact on the Group's net assets or results.

### (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.

Bournemouth Water's operations and licence were merged into South West Water on 1 April 2016 and the integration process has resulted in no separately identifiable business unit, and therefore revenue is presented as a single entity.

## 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) Goodwill

Goodwill arising on consolidation from the acquisition of subsidiary undertakings represents the excess of the purchase consideration over the fair value of net assets acquired, less any subsequent impairment charges.

Goodwill is recognised as an asset and reviewed for impairment at least annually. Any impairment is recognised immediately in the income statement and is not subsequently reversed. For the purpose of impairment testing, goodwill acquired in a business combination is allocated to each of the cash generating units or group of cash generating units, that is expected to benefit from the synergies of the combination. Each unit or group of units to which goodwill is allocated represents the lowest level within the entity at which the goodwill is monitored for internal reporting purposes. Goodwill is allocated and monitored at the reportable operating segment level. Further details are contained in accounting policy (i).

When a subsidiary undertaking is sold, the profit or loss on disposal is determined after including the attributable amount of unamortised goodwill.

### (f) Other tangible assets

Other intangible assets include assets acquired in a business combination and are capitalised at fair value at the date of acquisition. Following initial recognition, finite life intangible assets are amortised on a straight-line basis over their estimated useful lives, with the expense charged to the income statement through operating costs.

### (g) 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 (u).

## 2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

The assets residual value and useful lives are reviewed annually.

An initial review was carried out on the Bournemouth Water assets and they were broadly in line with those of the South West Water therefore no adjustments were made to residual values or useful lives.

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

### (h) 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 on a straight basis over the life of the lease.

### (i) 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.

### (j) 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.

### (k) 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.

### (l) 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.

### (m) 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.

### (n) 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.

## 2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

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.

### (o) 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.

## 2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

### (p) 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.

### (q) 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.

### (r) 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.

### (s) Employee benefits

#### i) Retirement benefit obligations

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

#### Defined benefit pension schemes

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

The movement in the fair value of scheme assets and the present value of scheme liabilities are shown in notional interest within finance income and cost. Changes in benefits granted by the employer are recognised immediately as past service cost in the income statement.

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

#### Defined contribution scheme

Costs of the defined contribution pension scheme are charged to the income statement in the 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.

### (t) 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.

## 2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

### (u) Transfers of assets from customers

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

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

### (v) 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.

#### 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 65% (2016: 74%) of net borrowings were at fixed rates and 24% (2016: 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 19.

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

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

For 2017 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 increased/ decreased by £0.2m (2016 £0.2m), for the equity sensitivity fair value, derivative impacts are excluded.

For 2017 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 £1.9m (2016 £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 22.

### 3. FINANCIAL RISK MANAGEMENT (CONTINUED)

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

31 March 2017	Due within 1 year £m	Due between 1 and 2 years £m	Due between 2 and 5 years £m	Over 5 years £m	Total £m
<b>Non-derivative financial liabilities</b>					
Borrowings excluding finance lease liabilities	141.1	32.0	110.4	753.4	1,036.9
Interest payments on borrowings	20.3	20.5	60.9	585.4	687.1
Finance lease liabilities including interest	31.5	31.4	175.7	1,893.4	2,132.0
<b>Derivative financial liabilities</b>					
Derivative contracts – net payments	12.5	11.1	10.4	0.8	34.8
31 March 2016	Due within 1 year £m	Due between 1 and 2 years £m	Due between 2 and 5 years £m	Over 5 years £m	Total £m
<b>Non-derivative financial liabilities</b>					
Borrowings excluding finance lease liabilities	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
<b>Derivative financial liabilities</b>					
Derivative contracts – net payments	12.2	10.0	15.2	0.5	37.9

#### iii) Credit risk

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

Counterparty risk arises from the investment of surplus funds and from the use of derivative financial instruments. The Board has agreed a policy for managing such risk, which is controlled through credit limits, counterparty approvals, and rigorous monitoring procedures.

The company has no other significant concentration of credit risk. Surplus funds of the company are usually placed in short-term fixed interest deposits or the overnight money markets. Deposit counterparties must meet a board approved minimum criteria based on their short term credit rating.

#### (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 2017 the company had cash and committed facilities excluding restricted funds of almost £536m, 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 31 and is calculated as total borrowings less cash and cash deposits. Total capital is calculated as equity plus net borrowings.

The gearing ratios at the balance sheet date were:

	2017 £m	2016 £m
Net Borrowings (note 31)	2,033.8	1,793.3
Total equity	565.2	530.4
<b>Total capital</b>	<b>2,599.0</b>	<b>2,323.7</b>
<b>Gearing Ratio</b>	<b>78.3%</b>	<b>77.2%</b>

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 increased to 61.8%, which compares to Ofwat's K6 target for efficient gearing of 62.5%.

### 3. FINANCIAL RISK MANAGEMENT CONTINUED

	2017	2016
	£m	£m
Regulatory Capital Value	3,290.6	2,997.3
Net borrowings (note 31)	2,033.8	1,793.3
<b>Net borrowings / Regulatory Capital Value</b>	<b>61.8%</b>	<b>59.8%</b>

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

#### (c) Determination of fair values

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

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

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

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

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

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 2017 the Company's current amounts receivable from customers were £210.4m, against which £91.4m had been provided for impairment (note 18).

#### 4. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES CONTINUED

##### (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 2016.

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 2015 actuarial tables with an allowance for future longevity improvement. The principal assumptions used to measure schemes' liabilities, sensitivities to changes in those assumptions and future funding obligations are set out in note 24 of the financial statements.

##### (d) Taxation

The company's current tax provision of £12.2m relates to management's judgement of the amount of tax payable.

In 2015/16 the company reported significant judgement around uncertain tax items related to the interpretation of tax legislation regarding financial arrangements entered in to in the normal course of business. Following engagement and subsequently resolution with HMRC across a number of areas, achieved through a process designed to expedite outstanding tax matters, these items are no longer an area of significant judgement.

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

The Company's accounting policy for property, plant and equipment is detailed in note 2 (g) of the financial statements. The carrying value of property, plant and equipment as at 31 March 2017 was £2,899.8. In the year ended 31 March 2017 additions to property, plant and equipment totalled £190.9m and the depreciation charge was £116.3m. 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.

##### (f) Non-underlying items

In establishing which items are disclosed separately as non-underlying, to enable a full understanding of the Group's financial performance, the Directors exercise their judgement in assessing the size, nature or incidence of specific items. See note 5 for further details.

#### 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 in the year and business trends over time.

	Notes	2017 £m	2016 £m
Restructuring costs	26	(0.5)	(5.2)
<b>Net operating costs</b>		<b>(0.5)</b>	<b>(5.2)</b>
<i>Tax arising on non-underlying item:</i>			
Tax credit / (charge) arising on non-underlying items	8	0.1	1.0
Deferred tax – change in rate	8	14.3	26.8
<b>Net non-underlying credit</b>		<b>13.9</b>	<b>22.6</b>

During the year a one-off charge of £0.5m was made to the restructuring provision reflecting announced reorganisations across the Company.

Following the enactment during the year the rate of corporation tax reduced from 18% to 17% from April 2020, as a result a 'one off' credit of £14.3m has been recognised in the income statement.

In addition, a charge of £0.8m has been recognised in the Statement of Comprehensive Income and a credit of £0.1m has been recognised, in equity directly.

## 6. OPERATING COSTS BEFORE NON-UNDERLYING ITEMS

	2017	2016
	£m	£m
Employment costs before non-underlying items (note 10)	46.7	40.3
Raw materials and consumables	19.2	15.7
<i>Other operating expenses include</i>		
Profit on disposal of property, plant and equipment	(2.1)	(1.4)
<i>Operating lease rentals payable:</i>		
Plant and machinery	1.3	1.4
Property	1.5	1.6
Research and development expenditure	0.2	0.1
Trade receivables impairment (note 18)	6.4	7.7
<i>Depreciation of property, plant and equipment:</i>		
Owned assets	79.1	69.5
Under finance leases	34.2	33.3
	<u>113.3</u>	<u>102.8</u>
Amortisation of other intangible assets	0.5	-
Total Depreciation	<u>113.8</u>	<u>102.8</u>

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

	2017	2016
	£000	£000
Fees payable to the Company's auditors and its associates for the audit of the financial statements	212	207
Fees payable to the Company's auditors and its associates for other services:		
All other services	73	19
<b>Total fees</b>	<u>285</u>	<u>226</u>

Expenses reimbursed to the auditors in relation to the audit of the Company were £14,000 (2016: £16,000).

A description of the work of the Audit Committee is set out in its report on page 46 to 54 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

	2017			2016		
	Finance cost £m	Finance income £m	Total £m	Finance cost £m	Finance income £m	Total £m
Cost of servicing debt						
Bank borrowings and overdrafts	(13.9)		(13.9)	(9.7)	-	(9.7)
Interest element of finance lease rentals	(29.5)		(29.5)	(31.4)	-	(31.4)
Other finance costs	(2.9)		(2.9)	(2.2)	-	(2.2)
Interest receivable	-	1.5	1.5	-	2.8	2.8
Intercompany interest to parent	(0.7)		(0.7)	(1.0)	-	(1.0)
Intercompany interest to subsidiaries	(15.2)		(15.2)	(12.5)		(12.5)
<b>Working capital adjustment</b>	<u>(62.2)</u>	<u>1.5</u>	<u>(60.7)</u>	<u>(56.8)</u>	<u>2.8</u>	<u>(54.0)</u>
Notional interest						
Retirement benefit obligations (note 24)	(0.7)	-	(0.7)	(1.4)	-	(1.4)
<b>Finance (costs) /income</b>	<u>(62.9)</u>	<u>1.5</u>	<u>(61.4)</u>	<u>(58.2)</u>	<u>2.8</u>	<u>(55.4)</u>

In addition to the above, finance costs of £2.8m (2016: £1.4m) have been capitalised on qualifying assets included in property, plant and equipment.

## 8. TAXATION

	Before non- underlying items 2017 £m	Non- underlying items (note 5) 2017 £m	Total 2017 £m	Before non- underlying items 2016 £m	Non-underlying items (note 5) 2016 £m	Total 2016 £m
<b>Analysis of charge in year</b>						
<i>Current tax</i>						
Current year tax charge	32.2	-	32.2	27.2	(1.0)	26.2
Prior year tax charge	(0.6)		(0.6)	(10.5)	-	(10.5)
Total current tax charge	<b>31.6</b>	<b>-</b>	<b>31.6</b>	<b>16.7</b>	<b>(1.0)</b>	<b>15.7</b>
<i>Deferred tax</i>						
Current year tax charge	3.6	(0.1)	3.5	5.7	-	5.7
Prior year tax charge	1.9		1.9	(0.2)	-	(0.2)
Deferred tax arising on change of rate of corporation tax (note 25)	-	(14.3)	(14.3)	-	(26.8)	(26.8)
Total deferred tax charge / (credit)	<b>5.5</b>	<b>(14.4)</b>	<b>(8.9)</b>	<b>5.5</b>	<b>(26.8)</b>	<b>(21.3)</b>
Total charge/ (credit) for the year	<b>37.1</b>	<b>(14.4)</b>	<b>22.7</b>	<b>22.2</b>	<b>(27.8)</b>	<b>(5.6)</b>

UK Corporation tax is calculated at 20% (2016: 20%) of the estimated assessable profit for the year.

The 2017 deferred tax credit includes a credit of £14.3m (2016: £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% (2016: 20%). The differences are explained below:

	2017 £m	2016 £m
Profit before tax	172.9	154.4
Profit before tax multiplied by the standard rate of corporation tax in the UK of 20% (2016: 20%)	34.6	30.9
<i>Effects of:</i>		
Expenses not deductible for tax purposes	0.5	-
Depreciation charged on non qualifying assets	1.3	1.4
Profit on the disposal of non qualifying assets	(0.4)	(0.3)
Adjustments to tax charge in respect of prior year	1.3	(10.7)
Change in rate of corporation tax	(14.3)	(26.8)
Other	(0.3)	(0.1)
Tax charge / (credit) for year	<b>22.7</b>	<b>(5.6)</b>

The adjustments to the tax charge in respect of prior years include; credit being taken in relation to research and development claims, submission of the prior year tax returns resulting in lower tax being due compared to the assessment made for the 2015/16 charge, together with a reassessment on the impact of the change of rate of corporation tax on the opening deferred tax balance.

The average effective tax rate excluding non-underlying items for the year was 21% (2016: 14%).

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:

	2017 £m	2016 £m
<b>Amounts recognised directly in other comprehensive income</b>		
Deferred tax charge on defined benefit pension schemes	(1.0)	1.4
Deferred tax credit on cash flow hedges	0.9	(0.6)
<b>Amounts recognised directly in equity</b>		
Deferred tax charge on share based payments	0.2	0.1

## 9. DIVIDENDS

	2017 £m	2016 £m
Amounts recognised as distributions to equity holders in the year:		
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
Base and enhanced dividend of 23.3p per ordinary share in respect of 2016/17 and 2015/16 paid 26 September 2016	58.4	-
Dividend of 21.8p per ordinary share in respect of outperformance 2015/16 paid 26 September 2016	54.7	-
Special dividend of 39.8p per ordinary share paid 26 September 2016	100.0	-
	<u>213.1</u>	<u>74.9</u>

## 10. EMPLOYMENT COSTS

The average number of persons (including Executive Directors) employed by the Company was 1,427 (2016: 1,278).

	Note	2017 £m	2016 £m
Wages and salaries		46.1	38.9
Social security costs		4.7	3.4
Pension costs	24	7.1	7.3
Share-based payments		0.9	1.1
Non-underlying items (note 5)		0.5	4.7
<b>Total employment costs</b>		<u>59.3</u>	<u>55.4</u>
Charged as follows:			
Employee costs		46.7	40.3
Capital schemes		12.1	10.4
Non-underlying items (note 5)		0.5	4.7
<b>Total employment costs</b>		<u>59.3</u>	<u>55.4</u>

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

	2017 £000	2016 £000
Executive Directors:		
Salary	635	732
Performance-related bonus paid or payable	234	257
Share-based payments	182	501
Other emoluments, including payments in lieu of pension provision	206	293
Non-executive Directors (including Chairman)	346	338
<b>Total emoluments</b>	<u>1,603</u>	<u>2,121</u>

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 65 to 93. 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 28.

The aggregate gains on vesting of Directors' share-based awards amounted to a total of £308,000.

Total gains made by Directors on the exercise of share options were £4,145 (2016: £nil).

At 31 March 2017 there was one Director accruing retirement benefits under defined benefit pension schemes (2016: one Director). At 31 March 2017 there was one Director accruing retirement benefits under defined contribution pension schemes (2016: one) with contributions of £12,810 made during the year (2016: £10,350).

## 12. GOODWILL

	2017 £m	2016 £m
<b>Cost</b>		
At 1 April 2016	-	-
Arising on acquisitions	51.3	-
<b>At 31 March 2017</b>	<b>51.3</b>	<b>-</b>

Goodwill of £51.3m has been recognised on acquisition of Bournemouth Water (see note 16). This is attributable to synergies and outperformance arising from the merger of operating activities.

### Impairment testing of goodwill

The Group tests goodwill for impairment annually or more frequently if there are any indications that impairment may have arisen. The recoverable amount, for which goodwill was recognised on acquisition of Bournemouth Water in 2016, is assessed using level 2 fair value hierarchy techniques, with reference to the market value of the merged water business, using a market based observable premium to Regulated Capital Value.

## 13. OTHER ACQUIRED INTANGIBLE ASSETS

	Total £m
<b>Cost:</b>	
At 1 April 2016	-
Arising on acquisitions	2.0
<b>At 31 March 2017</b>	<b>2.0</b>
<b>Aggregated impairment</b>	
At 1 April 2016	-
Charge for period	0.5
<b>At 31 March 2017</b>	<b>0.5</b>
<b>Carrying amount</b>	
At 1 April 2016	-
At 31 March 2017	1.5
<b>Weighted average useful economic life:</b>	
On acquisition	5 years
At period end	5 years

Other acquired intangible assets relate to computer software and arose on the acquisition of Bournemouth Water.

#### 14. 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
<b>Cost:</b>						
<b>At 31 March 2015</b>	<b>27.4</b>	<b>1,629.7</b>	<b>657.7</b>	<b>1,385.9</b>	<b>154.9</b>	<b>3,855.6</b>
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)	-
<b>At 31 March 2016</b>	<b>35.5</b>	<b>1,688.6</b>	<b>673.1</b>	<b>1,490.2</b>	<b>93.4</b>	<b>3,980.8</b>
Arising on acquisitions	7.3	75.0	21.9	37.3	1.2	142.7
Additions	0.2	12.7	1.2	46.8	130.0	190.9
Assets adopted at fair value	-	5.4	14.0	5.1	-	24.5
Grants & contributions	-	(1.7)	-	-	-	(1.7)
Disposals	-	(1.2)	(0.2)	(2.4)	-	(3.8)
Transfers/reclassifications	2.8	16.3	3.5	39.6	(62.2)	-
<b>At 31 March 2017</b>	<b>45.8</b>	<b>1,795.1</b>	<b>713.5</b>	<b>1,616.6</b>	<b>162.4</b>	<b>4,333.4</b>
<b>Accumulated depreciation:</b>						
<b>At 1 April 2015</b>	<b>6.9</b>	<b>189.7</b>	<b>219.9</b>	<b>802.2</b>	<b>-</b>	<b>1,218.7</b>
Charge for year	1.1	21.1	11.8	71.1	-	105.1
Disposals	-	(1.2)	-	(1.7)	-	(2.9)
<b>At 31 March 2016</b>	<b>8.0</b>	<b>209.6</b>	<b>231.7</b>	<b>871.6</b>	<b>-</b>	<b>1,320.9</b>
Charge for year	1.6	23.8	13.1	77.8	-	116.3
Disposals	-	(1.2)	(0.2)	(2.2)	-	(3.6)
<b>At 31 March 2017</b>	<b>9.6</b>	<b>232.2</b>	<b>244.6</b>	<b>947.2</b>	<b>-</b>	<b>1,433.6</b>
<b>Net book value:</b>						
<b>At 31 March 2015</b>	<b>20.5</b>	<b>1,440.0</b>	<b>437.8</b>	<b>583.7</b>	<b>154.9</b>	<b>2,636.9</b>
<b>At 31 March 2016</b>	<b>27.5</b>	<b>1,479.0</b>	<b>441.4</b>	<b>618.6</b>	<b>93.4</b>	<b>2,659.9</b>
<b>At 31 March 2017</b>	<b>36.2</b>	<b>1,562.9</b>	<b>468.9</b>	<b>669.4</b>	<b>162.4</b>	<b>2,899.8</b>

Out of the total depreciation charge for the company of £116.3m (2016: £105.1m), the sum of £1.5m (2016: £1.4m) has been charged to capital projects, £1.5m (2016: £0.9m) has been offset by deferred income and £113.3m (2016: £102.8m) against profits.

Asset lives and residual values are reviewed annually.

During the year borrowing costs of £2.8m (2016: £1.4m) have been capitalised on qualifying assets, at an average borrowing rate of 3.7%.

#### 14. PROPERTY, PLANT AND EQUIPMENT CONTINUED

Assets held under finance leases were:

	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant, vehicles and computers £m	Construction in progress £m	Total £m
<b>Cost:</b>					
At 31 March 2016	409.0	432.3	424.6	0.2	1,266.1
At 31 March 2017	409.0	436.7	424.8	0.2	1,270.7
<b>Accumulated depreciation:</b>					
At 31 March 2016	52.6	104.1	203.9	-	360.6
At 31 March 2017	58.3	111.5	224.8	-	394.6
<b>Net book amount:</b>					
At 31 March 2016	356.4	328.2	220.7	0.2	905.5
At 31 March 2017	350.7	325.2	200.0	0.2	876.1

#### 15. 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
<b>31 March 2017</b>					
<b>Financial assets</b>					
Trade and other receivables	18	-	16.3	119.0	135.3
Cash and cash deposits	20	-	247.4	-	247.4
		-	263.7	119.0	382.7
<b>Financial liabilities</b>					
Borrowings	22	-	(2,281.2)	-	(2,281.2)
Derivative financial instruments	19	(39.1)	-	-	(39.1)
Trade and other payables	21	-	(3.3)	(56.7)	(60.0)
		(39.1)	(2,284.5)	(56.7)	(2,380.3)

	Note	Fair value Derivatives used for cash flow hedging £m	Amortised cost Loans and receivables £m	Trade receivables and trade payables £m	Total £m
<b>31 March 2016</b>					
<b>Financial assets</b>					
Trade and other receivables	18	-	7.7	103.1	110.8
Cash and cash deposits	20	-	251.2	-	251.2
		-	258.9	103.1	362.0
<b>Financial liabilities</b>					
Borrowings	22	-	(2,044.5)	-	(2,044.5)
Derivative financial instruments	19	(43.7)	-	-	(43.7)
Trade and other payables	21	-	(2.6)	(48.3)	(50.9)
		(43.7)	(2,047.1)	(48.3)	(2,139.1)

## 16. INVESTMENTS

	2017 £m	2016 £m
At 31 March:		
Subsidiary undertakings	3.3	3.3

The Company has four wholly-owned subsidiaries, Peninsula Properties (Exeter) Limited, South West Water Finance Plc, Source Contact Management Limited and its subsidiary Source Collections Limited. All of these subsidiaries are registered at Peninsula House, Rydon Lane, Exeter, Devon, England, EX2 7HR and are also incorporated and operate in England. The Company also has a minority shareholding of Landlord Tap Limited, which is incorporated, registered and operates in England.

On 1 April 2016 the Company bought the entire share capital of Bournemouth Water Investments Limited from Pennon Group plc for £104m. The consideration was satisfied through Pennon Group plc subscribing for an additional £100m of new share capital in South West Water Limited and transferring a £4 million loan due to Bournemouth Water Limited to South West Water Limited. A breakdown of the purchased assets and liabilities is below

	Provisional Fair Value £m
Other Intangible Assets	2.0
Property, plant & equipment	142.7
Inventories	0.2
Receivables	6.8
Payables	(3.9)
Retirement benefit obligations	7.1
Taxation –current	(1.4)
Taxation – deferred	(17.5)
Cash & Deposits	8.3
Loans	(90.0)
Leases	(5.6)
Net assets acquired	48.7
Goodwill	51.3
<b>Total Consideration</b>	<b>100.0</b>

On 31 March 2017, Source For Business Limited was sold to Pennon Group plc at the balance sheet investment cost of £20,000. Trade balances and loans of £0.4m with Source For Business were written off at the balance sheet date. This has had £0.4m impact on profit before interest, depreciation and amortisation.

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.

## 17. INVENTORIES

	2017 £m	2016 £m
Raw materials and consumables	5.3	5.5

## 18. TRADE AND OTHER RECEIVABLES – CURRENT

	2017	2016
	£m	£m
Amounts receivable from customers	210.4	191.8
Less: provision for impairment of receivables	(91.4)	(88.7)
<b>Net trade receivables</b>	<b>119.0</b>	<b>103.1</b>
Amounts owed by fellow subsidiary companies	1.3	1.3
Amounts owed by parent undertaking	-	0.2
Other receivables	15.0	6.2
Prepayments and accrued income	6.9	6.6
	<b>142.2</b>	<b>117.4</b>

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

With the sale of Source for Business, the Company incurred a write off of intercompany trade receivables and loans amounting to £0.4m.

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:

	2017	2016
	£m	£m
Past due 1 - 30 days	20.0	12.7
Past due 31 - 120 days	20.4	15.5
More than 120 days	148.3	143.3

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:

	2017	2016
	£m	£m
<b>At 1 April</b>	<b>88.7</b>	<b>81.0</b>
Acquisition provision for receivables impairment	0.8	
Provision for receivables impairment	6.4	7.7
Net Receivables written-off during the year as uncollectable	(4.5)	-
<b>At 31 March</b>	<b>91.4</b>	<b>88.7</b>

## 19. DERIVATIVE FINANCIAL INSTRUMENTS

	2017 £m	2016 £m
Derivatives used for cash flow hedging:		
Current liabilities	(15.2)	(14.4)
Non-current liabilities	(23.9)	(29.3)

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

The ineffective portion recognised in the income statement arising from cash flow hedges was £nil (2016: £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 2017, 65% (2016: 74%) of net borrowings was at fixed rate.

At 31 March 2017 interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £978.0m existed, with a weighted average maturity of 3.0 years (2016: £978.0m, with 4 years). The weighted average interest rate of the swaps was 2.05% (2016: 2.05%).

The periods for which cash flow hedges are expected to affect future profit or loss as follows:

	<1 year £m	1-2 years £m	2-5 years £m	Over 5 years £m	Total £m
<b>31 March 2017</b>					
Liabilities	(15.2)	(11.3)	(11.9)	(0.7)	(39.1)
<b>31 March 2016</b>					
Liabilities	(14.4)	(10.1)	(18.9)	(0.3)	(43.7)

### Valuation hierarchy

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

	2017 £m	2016 £m
<b>Level 2 inputs</b>		
<b>Liabilities</b>		
Derivatives used for cash flow hedging	(39.1)	(43.7)

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.

## 20. CASH AND CASH DEPOSITS

	2017	2016
	£m	£m
Cash at bank and in hand	25.7	1.9
Other short-term bank deposits	-	35.3
Other deposits	221.7	214.0
<b>Cash and cash deposits</b>	<b>247.4</b>	<b>251.2</b>

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

Other deposits include £221.7m (2016: £214.0m) of restricted funds to settle long-term lease liabilities (note 22)

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

	2017	2016
	£m	£m
Cash and cash deposits as above	247.4	251.2
Less: deposits with a maturity of three months or more (restricted funds)	(221.7)	(214.0)
<b>Cash and cash equivalents</b>	<b>25.7</b>	<b>37.2</b>

## 21. TRADE AND OTHER PAYABLES – CURRENT

	2017	2016
	£m	£m
Trade payables	56.7	48.3
Amounts owed to subsidiary companies	3.3	2.6
Other tax and social security	1.6	1.4
Other payables	8.2	7.7
Accruals	21.5	18.1
Deferred income	2.2	1.2
	<b>93.5</b>	<b>79.3</b>

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

## 22. BORROWINGS

	2017	2016
	£m	£m
<b>Current</b>		
Loan from parent company (note 35)	100.0	50.0
European Investment Bank	41.1	38.7
	<b>141.1</b>	<b>88.7</b>
Obligations under finance leases	17.2	15.9
<b>Total current borrowings</b>	<b>158.3</b>	<b>104.6</b>
<b>Non-current</b>		
European Investment Bank	323.4	234.4
Other external loans	171.6	80.0
Loan from subsidiary company (note 35)	400.8	394.9
	<b>895.8</b>	<b>709.3</b>
Obligations under finance leases	1,227.1	1,230.6
	<b>2,122.9</b>	<b>1,939.9</b>
<b>Total borrowings</b>	<b>2,281.2</b>	<b>2,044.5</b>

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.

## 22. BORROWINGS CONTINUED

The fair value of the non-current borrowings were:

	2017 Book value £m	2017 Fair value £m	2016 Book value £m	2016 Fair value £m
European Investment Bank	323.4	282.3	234.4	209.3
Other external loans	171.6	277.0	80.0	80.0
Loan from subsidiary company	400.8	497.8	394.9	418.4
	<b>895.8</b>	<b>1,057.1</b>	<b>709.3</b>	<b>707.7</b>
Obligations under finance leases	1,227.1	1,120.3	1,230.6	1,083.5
	<b>2,122.9</b>	<b>2,177.4</b>	<b>1,939.9</b>	<b>1,791.2</b>

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

The maturity of non-current borrowings was:

	2017 £m	2016 £m
Between 1 and 2 years	48.0	57.6
Over 2 and less than 5 years	246.2	181.1
Over 5 years	1,828.7	1,701.2
	<b>2,122.9</b>	<b>1,939.9</b>

The weighted average maturity of non-current borrowings was 24.5 years (2016: 25 years).

Finance lease liabilities – minimum lease payments:

	2017 £m	2016 £m
Within 1 year	31.5	31.4
Over 1 year and less than 5 years	207.1	191.3
Over 5 years	1,893.4	2,076.1
	<b>2,132.0</b>	<b>2,298.8</b>
Less: future finance charges	(887.7)	(1,052.3)
<b>Present value of finance lease liabilities</b>	<b>1,244.3</b>	<b>1,246.5</b>

The maturity of finance lease liabilities was:

	2017 £m	2016 £m
Within 1 year	17.3	15.9
Over 1 year and less than 5 years	143.8	95.6
Over 5 years	1,083.2	1,135.0
	<b>1,244.3</b>	<b>1,246.5</b>

Included above are accrued finance charges arising on obligations under finance leases totalling £144.9m (2016: £137.7m), of which £0.6m (2016: £0.5m) is repayable within one year.

Included above is £0.8m (2016: £0.6m) due to Peninsula Leasing Limited (a fellow Pennon Group subsidiary), under finance lease agreements of which £0.4m (2016: £0.3m) is repayable within one year.

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 £79.3m at 31 March 2017 (2016: £71.7m) 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 2017 of £142.4m (2016: £142.3m) 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.

## 22. BORROWINGS CONTINUED

Undrawn committed borrowing facilities at the balance sheet date were:

	2017 £m	2016 £m
Floating rate:		
Expiring within one year	-	50.0
Expiring after one year	510.0	635.0
	<u>510.0</u>	<u>685.0</u>

In addition, the company has undrawn uncommitted short-term bank facilities of £15.0m (2016: £25.0m).

## 23. OTHER NON-CURRENT LIABILITIES

	2017 £m	2016 £m
Deferred income	<u>102.4</u>	<u>80.5</u>

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

## 24. RETIREMENT BENEFIT OBLIGATIONS

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

The assets of the Pennon Group's pension schemes are held in separate trustee-administered funds. The trustees of the funds are required to act in the best interest of the funds' beneficiaries. The appointment of the schemes' trustees is determined by the schemes' trust documentation. The Pennon Group has a policy for the main fund that one-half of all trustees, other than the Chairman, are nominated by members of the schemes, including pensioners.

### Defined contribution schemes

Pension costs for defined contribution schemes were £1.3m (2016: £1.9m).

### Defined benefit schemes

The principal actuarial assumptions at 31 March 2017 were:

	2017 %	2016 %	2015 %
Rate of increase in pensionable pay	3.2	2.9	2.9
Rate of increase for current and future pensions	2.0	2.8	2.9
Rate used to discount schemes' liabilities and expected return on scheme assets	2.6	3.3	3.4
Inflation	3.2	2.9	2.9

### 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 2015 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:

	2017	2016	2015
Male	24.8	25.1	25.0
Female	27.2	27.3	27.2

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

	2017	2016	2015
Male	26.2	26.5	26.4
Female	29.5	29.6	29.5

## 24. RETIREMENT BENEFIT OBLIGATIONS CONTINUED

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%	+/- 0.6%
Rate of increase in current and future pensions	+/- 0.5%	+/- 6.2%
Rate used to discount schemes' liabilities	+/- 0.5%	+/- 9.3%
Inflation	+/- 0.5%	+/- 6.4%
Life expectancy	+/- 1 year	+/- 4.5%

The sensitivity analysis shows the effect of changes in the principal assumptions used for the measurement of the pension liability. The method used to calculate the sensitivities is approximate and has been determined taking into account the duration of the liabilities and the overall profile of each scheme's membership. This is the same approach as has been adopted in previous years.

The amounts recognised in the balance sheet were:

	2017 £m	2016 £m
Present value of financial obligations	(658.6)	(500.8)
Fair value of plan assets	626.3	471.2
<b>Net liability recognised in the balance sheet</b>	<b>(32.3)</b>	<b>(29.6)</b>

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

	2017			2016		
	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
<b>At 1 April</b>	<b>(500.8)</b>	<b>471.2</b>	<b>(29.6)</b>	<b>(501.8)</b>	<b>460.3</b>	<b>(41.5)</b>
<b>Acquisition of subsidiary</b>	<b>(79.5)</b>	<b>86.6</b>	<b>7.1</b>	-	-	-
Current service cost	(5.4)	-	(5.4)	(5.4)	-	(5.4)
Interest (expense)/income	(18.8)	18.1	(0.7)	(16.6)	15.2	(1.4)
Past service cost and gains and losses on settlements	(0.4)	-	(0.4)	-	-	-
	<b>(24.6)</b>	<b>18.1</b>	<b>(6.5)</b>	<b>(22.0)</b>	<b>15.2</b>	<b>(6.8)</b>
<b>Remeasurements:</b>						
Return / (loss) on plan on assets excluding amounts included in interest expense	-	71.8	71.8	-	(8.7)	(8.7)
Loss from change in financial assumptions	(79.5)	-	(79.5)	-	-	-
Experience gains	-	-	-	5.1	-	5.1
	<b>(79.5)</b>	<b>71.8</b>	<b>(7.7)</b>	<b>5.1</b>	<b>(8.7)</b>	<b>(3.6)</b>
<b>Contributions:</b>						
Employers	-	4.4	4.4	-	22.3	22.3
Plan participants	(0.1)	0.1	-	(0.1)	0.1	-
Payments from plans:						
Benefit payments	25.9	(25.9)	-	18.0	(18.0)	-
	<b>25.8</b>	<b>(21.4)</b>	<b>4.4</b>	<b>17.9</b>	<b>4.4</b>	<b>22.3</b>
<b>At 31 March</b>	<b>(658.6)</b>	<b>626.3</b>	<b>(32.3)</b>	<b>(500.8)</b>	<b>471.2</b>	<b>(29.6)</b>

## 24. RETIREMENT BENEFIT OBLIGATIONS CONTINUED

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 33).

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

	2017			2016		
	Quoted prices in active market £m	Prices not quoted in active market £m	Fund %	Quoted prices in active market £m	Prices not quoted in active market £m	Fund %
Equities	148.1	-	23	141.3	-	30
Property	41.2	7.0	8	39.8	-	8
Bonds	275.3	-	44	175.1	-	37
Diversified Growth Fund	61.1	-	10	55.4	-	12
Insurance linked securities	37.3	-	6	-	-	-
Other	56.3	-	9	59.6	-	13
	<b>619.3</b>	<b>7.0</b>	<b>100</b>	<b>471.2</b>	<b>-</b>	<b>100</b>

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 holds a significant proportion of growth assets (equities, diversified growth funds and property) which are expected to outperform corporate bonds in the long-term while providing 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 market movements in 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 2016. The Company did not make deficit recovery contribution to the main scheme during the year (2016 £18.3 million). Pennon Group plc monitors funding levels on an annual basis and expects to pay total contributions of around £10.0m during the year ended 31 March 2018. This is in line with our K6 commitments.

## 25. 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:

	2017	2016
	£m	£m
<b>At 1 April</b>	<b>211.8</b>	<b>232.2</b>
Arising on acquisitions	17.5	-
Impact of change of corporation tax rate credited to the income statement	(14.3)	(26.8)
Impact of change of corporation tax rate charged to other comprehensive income	0.8	2.9
Impact of change of corporation tax rate charged to equity	(0.1)	0.1
Other non underlying credits in the income statement	(0.1)	-
Other deferred tax charged to the income statement	5.4	5.5
Credited to other comprehensive income / equity	(1.0)	(2.1)
<b>At 31 March</b>	<b>220.0</b>	<b>211.8</b>

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 £13.6m to recognise the changes in the rate of corporation tax enacted on 15 September 2016 to reduce the rate at 1 April 2020 from 18% to 17%, the Finance Act 2015 having previously reduced the rate to 19% from 1 April 2017 and 18% from 1 April 2020. The credit includes a credit of £14.3m recognised in the income statement and a debit of £0.7m recognised in the statement of comprehensive income and equity.

The movements in deferred tax assets and liabilities were:

### Deferred tax liabilities

	£m
	Accelerated tax depreciation
	£m
<b>At 31 March 2015</b>	<b>248.9</b>
Charged to the income statement	2.9
Non underlying credited to the income statement	(25.5)
<b>At 31 March 2016</b>	<b>226.3</b>
Arising on acquisitions	16.3
Impact of change of rate	(14.1)
Charged to the income statement	6.1
<b>At 31 March 2017</b>	<b>234.6</b>

## 25. DEFERRED TAX LIABILITIES CONTINUED

### Deferred tax assets

	Provisions	Retirement benefit obligations	Derivatives	Share based payments	Total
	£m	£m	£m	£m	£m
<b>At 31 March 2015</b>	<b>(0.9)</b>	<b>(8.3)</b>	<b>(6.8)</b>	<b>(0.7)</b>	<b>(16.7)</b>
(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)
Charged/(credited) to other comprehensive income / equity	-	(0.7)	(1.4)	-	(2.1)
Non-underlying charged to equity/ other comprehensive income	-	2.1	0.8	0.1	3.0
<b>At 31 March 2016</b>	<b>(1.2)</b>	<b>(5.3)</b>	<b>(7.4)</b>	<b>(0.6)</b>	<b>(14.5)</b>
Arising on acquisitions	(0.1)	1.3	-	-	1.2
Non-underlying charged/(credited) to the income statement	(0.4)	0.1	-	-	(0.3)
Credited to income statement	(0.3)	(0.4)	-	-	(0.7)
Charged/(credited) to other comprehensive income / equity	-	(1.4)	0.5	(0.1)	(1.0)
Non-underlying Charged/(credited) to equity/ other comprehensive income	-	0.4	0.4	(0.1)	0.7
<b>At 31 March 2017</b>	<b>(2.0)</b>	<b>(5.3)</b>	<b>(6.5)</b>	<b>(0.8)</b>	<b>(14.6)</b>

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

	2017 £m	2016 £m
Actuarial gains on defined benefit schemes	(1.0)	1.4
Share-based payments	(0.2)	0.1
Cash-flow hedges	0.9	(0.6)
	<b>(0.3)</b>	<b>0.9</b>

## 26. PROVISIONS

	2017 £m	2016 £m
<b>Restructuring</b>		
<b>At 1 April</b>	<b>6.7</b>	<b>2.0</b>
Charged to the income statement	0.5	5.2
Utilised during year	(2.3)	(0.5)
<b>At 31 March</b>	<b>4.9</b>	<b>6.7</b>

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

## 27. CALLED UP SHARE CAPITAL

	2017 £m	2016 £m
Authorised 500,000,000 (2016: 500,000,000) Ordinary shares of £1 each	500.0	500.0
Allotted and fully paid 250,923,000 (2016: 150,950,000) Ordinary shares of £1 each	250.9	150.9

## 28. EMPLOYEE SHARE SCHEMES

The company participates in a number of share plans for the benefit of employees operated by Pennon Group Plc. Details of each plan are set out below.

### i) Sharesave Scheme

An all-employee savings related plan is operated that enables employees to invest up to a maximum of £500 per month for three or five years. These savings can then be used to buy Ordinary shares, at a price set at a 17% 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	
			2017	2016
6 July 2009	386p	2012 – 2016	-	23
28 June 2010	431p	2013 – 2017	28	28
29 June 2011	536p	2014 – 2018	17	69
29 June 2012	588p	2015 – 2017	31	35
3 July 2013	538p	2016 – 2018	57	271
14 July 2014	611p	2017 – 2019	279	296
24 June 2015	683p	2018 – 2020	556	602
29 June 2016	709p	2019 – 2021	326	-
			<b>1,294</b>	<b>1,324</b>

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

	2017		2016	
	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	1,324	617	1,080	558
Granted	342	709	620	683
Exercised	(290)	528	(326)	548
Expired	(82)	663	(50)	617
<b>At 31 March</b>	<b>1,294</b>	<b>658</b>	<b>1,324</b>	<b>617</b>

The weighted average price at the date of exercise of Sharesave options during the year was 873p (2016: 779p). The options outstanding at 31 March 2017 had a weighted average exercise price of 658p (2016: 617p) and a weighted average remaining contractual life of 1.9 years (2016: 2.1 years).

## 28. EMPLOYEE SHARE SCHEMES CONTINUED

The aggregate fair value of Sharesave options granted during the year was £0.9m (2016: £0.8m), determined using the Black-Scholes valuation model. The significant inputs into the valuation model, at the date of issue of the options, were:

	2017	2016
Weighted average share price	854p	854p
Weighted average exercise price	709p	683p
Expected volatility	18.0%	17.0%
Expected life	3.4 years	3.4 years
Risk-free rate	0.3%	0.8%
Expected dividend yield	4.2%	4.0%

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

### ii) Performance and Co-investment Plan

Executive Directors and senior management receive a conditional award of Ordinary shares in Pennon Group Plc, and are also required to hold a substantial personal share holding in Pennon Group Plc. The eventual number of shares, if any, which vest is dependent upon the achievement of conditions of the plan over the restricted period, being not less than three years.

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

	2017		2016	
	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	366	749	357	735
Granted	68	920	119	810
Vested	(26)	653	-	769
Transferred to Pennon	(156)	-	-	-
Lapsed	(69)	653	(110)	769
<b>At 31 March</b>	<b>183</b>	<b>847</b>	<b>366</b>	<b>749</b>

The awards outstanding at 31 March 2017 had a weighted average exercise price of 873p (2016: 749p) and a weighted average remaining contractual life of 2.1 years (2016: 1.8 years).

The aggregate fair value of awards granted during the year was £0.4m (2016: £0.5m), determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were:

	2017	2016
Weighted average share price	920p	811p
Expected volatility	18.0%	17.0%
Risk-free rate	0.3%	0.8%

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

## 28. 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:

	2017		2016	
	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	160	768	149	758
Granted	44	950	62	791
Vested	(46)	693	(51)	755
Lapsed	(15)	798	-	-
<b>At 31 March</b>	<b>143</b>	<b>845</b>	<b>160</b>	<b>768</b>

The awards outstanding at 31 March 2017 had a weighted average price of 845p (2016: 768p) and a weighted average remaining contractual life of 2.4 years (2016: 2.4 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 £0.4m (2016: £0.5m), 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.

## 29. RETAINED EARNINGS AND OTHER RESERVES

	Hedging reserve £m	Retained earnings £m	Total £m
<b>At 31 March 2015</b>	<b>(27.3)</b>	<b>332.7</b>	<b>305.4</b>
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)
<b>At 31 March 2016</b>	<b>(33.8)</b>	<b>413.3</b>	<b>379.5</b>
Profit for the year	-	150.2	150.2
Other comprehensive income/(loss) for the year	4.2	(6.7)	(2.5)
Dividends paid	-	(213.1)	(213.1)
Share-based payments (including tax)	-	0.7	0.7
Pennon shares disposed on vesting of options	-	(0.5)	(0.5)
<b>At 31 March 2017</b>	<b>(29.6)</b>	<b>343.9</b>	<b>314.3</b>

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.

### 30. CASH FLOW FROM OPERATING ACTIVITIES

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

	2017 £m	2016 £m
Continuing operations		
Profit for the year	150.2	160.0
Adjustments for:		
Share based payments	0.9	1.1
Deferred income released to profits	(0.2)	(0.2)
Profit on disposal of property, plant and equipment	(2.1)	(1.3)
Depreciation charge	113.3	102.8
Amortisation of intangible fixed assets	0.5	-
Finance income	(1.5)	(2.8)
Finance charge	62.9	58.2
Taxation	22.7	(5.6)
Non underlying provision charge	0.5	5.2
Changes in working capital:		
Decrease / (increase) in inventories	0.2	(0.3)
(Increase) / decrease in trade and other receivables	(18.3)	1.5
Increase / (decrease) in trade and other payables	2.6	(2.6)
Increase / (decrease) in retirement benefit obligations	1.4	(16.9)
Decrease in provisions	(2.4)	(0.6)
<b>Cash generated from operations</b>	<b>330.7</b>	<b>298.5</b>

### 31. NET BORROWINGS

	2017 £m	2016 £m
<b>Cash and cash deposits</b>	<b>247.4</b>	<b>251.2</b>
Borrowings – current		
Loan from parent company	(100.0)	(50.0)
Other current borrowings	(41.1)	(38.7)
Finance lease obligations	(17.2)	(15.9)
<b>Total current borrowings</b>	<b>(158.3)</b>	<b>(104.6)</b>
Borrowings – non-current		
Other non-current borrowings	(895.8)	(709.3)
Finance lease obligations	(1,227.1)	(1,230.6)
<b>Total non-current borrowings</b>	<b>(2,122.9)</b>	<b>(1,939.9)</b>
<b>Total net borrowings</b>	<b>(2,033.8)</b>	<b>(1,793.3)</b>

### 32. OPERATING LEASE COMMITMENTS

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

	2017 £m	2016 £m
Within 1 year	1.9	1.5
Over 1 year and less than 5 years	7.1	5.4
Over 5 years	46.5	17.8
	<b>55.5</b>	<b>24.7</b>

### 33. CONTINGENT LIABILITIES

	2017 £m	2016 £m
Guarantee of borrowings of subsidiary undertaking	391.4	385.5

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.

### 34. CAPITAL COMMITMENTS

	2017 £m	2016 £m
Contracted but not provided	53.8	69.2

### 35. RELATED PARTY TRANSACTIONS

	2017 £m	2016 £m
<b>Parent company</b>		
Purchase of goods and services		
– Group expenses	5.3	4.9
Payment for provision of finance		
- Loan interest	0.6	1.0
Sale of goods and services		
– Administrative services	0.5	0.4
Dividends paid	213.1	74.9
	<b>2017 £m</b>	<b>2016 £m</b>
<b>Subsidiaries of the Company</b>		
Purchase of goods and services		
– Property consultancy	0.3	0.2
– Billing and collection services	9.9	9.3
Payment for provision of finance		
– Loan interest	15.2	12.4
Sale of goods and services (administrative services)	1.8	1.4
	<b>2017 £m</b>	<b>2016 £m</b>
<b>Fellow subsidiaries of the Pennon Group</b>		
Purchase of goods and services		
– Insurance premia	0.6	0.3
Payment for provision of finance		
– Finance lease charges: vehicles	-	-

### 35. RELATED PARTY TRANSACTIONS CONTINUED

	2017 £m	2016 £m
Year end balances		
Borrowings		
– Loan from parent	100.0	50.0
– Loan from subsidiary	400.8	394.9
– Finance lease balances with fellow subsidiary	0.8	0.6
Receivables		
– Parent company	0.5	0.2
– Fellow subsidiaries	0.9	0.3
Payables		
– Subsidiaries	3.0	2.6

Details of the £100.0m loan from the parent Company, Pennon Group Plc and the loan from the subsidiary, South West Water Finance are included in note 22.

### 36. POST BALANCE SHEET EVENT

On 1 April 2017, following the opening of the non-household retail market for water and wastewater services, South West Water Limited sold its non-household retail net customer book and related assets together totalling £32.4m to Pennon Water Services Limited (PWS) for consideration of £32.4m, resulting in a nil/gain loss of sale.

South West Water will continue to provide wholesale services in respect of household and non-household consumers in South West Water's area of supply (including the Bournemouth Water region). Therefore continuing to recognise significant revenues related to the water and wastewater services ultimately provided to non-household customers in these regions. The net operating profit that related to retail activity in 2016/17, that has been transferred to PWS on 1 April 2017, was not considered significant activity within South West Water.

Had this transaction occurred prior to 1 April 2016, South West Water's revenue in 2016/17 would have reduced by around £5m and profit before tax would have reduced by around £1.7m.

South West Water will continue to provide retail services to household customers in its area of supply.

### 37. 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.

Debbie O'Hanlon  
Ernst & Young LLP  
Apex Plaza  
Forbury Road  
Reading  
RG1 1YE  
United Kingdom

30 May 2017

Dear Ms O'Hanlon

This letter of representations is provided in connection with your audit of the financial statements of South West Water Limited ("the Company") for the year ended 31 March, 2017. enabling you to form an opinion as to whether the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of South West Water Limited as of 31 March, 2017 and of its financial performance (or operations) and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union.

We understand that the purpose of your audit of our financial statements is to express an opinion thereon and that your audit was conducted in accordance with International Standards on Auditing, which involves an examination of the accounting system, internal control and related data to the extent you considered necessary in the circumstances, and is not designed to identify - nor necessarily be expected to disclose - all fraud, shortages, errors and other irregularities, should any exist.

Accordingly, we make the following representations, which are true to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves:

**A. Financial statements and Financial Records**

1. We have fulfilled our responsibilities, as set out in the terms of the audit engagement letter dated 18 September 2014, for the preparation of the financial statements in accordance with, for the Company, International Financial Reporting Standards as adopted by the European Union.
2. We acknowledge, as members of management of the Company, our responsibility for the fair presentation of the financial statements. We believe the financial statements referred to above gives a true and fair view of (or 'present fairly, in all material respects') the financial position, financial performance (or results of operations) and cash flows of the Company in accordance with International Financial Reporting Standards as adopted by the European Union, and are free of material misstatements, including omissions. We have approved the financial statements.
3. As members of management of the Company, we believe that the Company have a system of internal controls adequate to enable the preparation of an accurate financial statements in accordance with International Financial Reporting Standards as adopted by the European Union for the Company that are free from material misstatement, whether due to fraud or error.
4. There are no unadjusted audit differences identified during the current audit and pertaining to the latest period presented.

## **B. Fraud**

1. We acknowledge that we are responsible for the design, implementation and maintenance of internal controls to prevent and detect fraud.
2. We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
3. We have disclosed to you all significant facts relating to any frauds, suspected frauds or allegations of fraud known to us that may have affected the Company (regardless of the source or form and including, without limitation, allegations by "whistle-blowers"), whether involving management or employees who have significant roles in internal control. Similarly, we have disclosed to you our knowledge of frauds or suspected frauds affecting the entity involving others where the fraud could have a material effect on the financial statements. We have also disclosed to you all information in relation to any allegations of fraud or suspected fraud communicated by employees, former employees, analysts, regulators or others, that could affect the financial statements.

## **C. Compliance with Laws and Regulations**

1. We have disclosed to you all identified or suspected non-compliance with laws and regulations whose effects should be considered when preparing the financial statements.

## **D. Information Provided and Completeness of Information and Transactions**

1. We have provided you with:
  - Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
  - Additional information that you have requested from us for the purpose of the audit; and
  - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
2. All material transactions have been recorded in the accounting records and are reflected in the financial statements.
3. We have made available to you all minutes of the meetings of shareholders, directors and committees of directors (or summaries of actions of recent meetings for which minutes have not yet been prepared) held through the year to the most recent meeting.
4. We confirm the completeness of information provided regarding the identification of related parties. We have disclosed to you the identity of the Company's related parties and all related party relationships and transactions of which we are aware, including sales, purchases, loans, transfers of assets, liabilities and services, leasing arrangements, guarantees, non-monetary transactions and transactions for no consideration for the period ended, as well as related balances due to or from such parties at the year end. These transactions have been appropriately accounted for and disclosed in the financial statements.
5. We believe that the significant assumptions we used in making accounting estimates, including those measured at fair value, are reasonable.
6. We have disclosed to you, and the Company has complied with, all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance, including all covenants, conditions or other requirements of all outstanding debt.

## **E. Liabilities and Contingencies**

1. All known liabilities and contingencies other than minor items associated with the normal course of business, including those associated with guarantees, whether written or oral, have been disclosed to you and are appropriately reflected in the financial statements.
2. We have informed you of all known outstanding and known possible litigation and claims other than minor litigations and claims received in the normal course of business, whether or not they have been discussed with legal counsel.
3. We have recorded and/or disclosed, as appropriate, all liabilities related to litigation and claims, both actual and contingent, and have disclosed in Note 36 to the financial statements all guarantees that we have given to third parties.

## **F. Subsequent Events**

1. Other than events described in the financial statements, there have been no events subsequent to period end which require adjustment of or disclosure in the financial statements or notes thereto.

## **G. Environmental Liabilities**

1. We have disclosed to you all known liabilities or contingencies arising from environmental matters other than minor items associated with the normal course of business for the Company. These liabilities or contingencies have been recognised, measured and disclosed, as appropriate, in the financial statements. The environmental liabilities included in the company balance sheet represents our best estimate of the potential losses using assumptions that we believe represent the expected outcomes of the uncertainties. With respect to the valuation of related assets, we have considered the effect of environmental matters, and the carrying value of the relevant assets is recognised, measured and disclosed, as appropriate, in the financial statements. Any commitments related to environmental matters have been measured and disclosed, as appropriate, in the financial statements.

## **H. Ownership of Assets**

1. Except for assets capitalised under finance leases, the Company has satisfactory title to all assets appearing in the balance sheet, and there are no liens or encumbrances on the Company's assets, nor has any asset been pledged as collateral. All assets to which the Company has satisfactory title appear in the balance sheet.
2. All agreements and options to buy back assets previously sold have been properly recorded and adequately disclosed in the financial statements.
3. There are no formal or informal compensating balance arrangements with any of our cash and investment accounts. Except as disclosed in Note 21, 24, 26 to the financial statements, we have no other line of credit arrangements.

## **I. Equity**

1. We have properly recorded or disclosed in the financial statements the share/capital stock repurchase options and agreements, and shares/capital stock reserved for options, warrants, conversions and other requirements.

## **J. Contingent Liabilities**

1. We are unaware of any violations or possible violations of laws or regulations the effects of which should be considered for disclosure in the financial statements or as the basis of recording a contingent loss (other than those disclosed or accrued in the financial statements).

2. We are unaware of any known or probable instances of non-compliance with the requirements of regulatory or governmental authorities, including their financial reporting requirements, and there have been no communications from regulatory agencies or government representatives concerning investigations or allegations of non-compliance, except as follows:
  - (1) Minor matters associated with the day to day operations of the Company.
  - (2) Matters of routine, normal, recurring nature (e.g., examinations by bank and insurance examiners, examinations by taxing authorities) none of which involves any allegations of noncompliance with laws or regulations that should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

#### **K. Income and Indirect Taxes**

1. We acknowledge our responsibility for the tax accounting methods adopted by the Company, which have been consistently applied in the current period, and for the current year income tax provision calculation.
2. We also acknowledge our responsibility for the plans with respect to future taxable income, which represent our estimates as to the outcome of those plans, based on available evidence, and for the significant assumptions used in our analysis. We would implement such strategies as necessary to prevent a tax operating loss or credit carryforward from expiring.
3. We have disclosed to you all tax opinions, correspondence with tax authorities, or other appropriate information that served as support for the accounting for potentially material matters.
4. We have also provided you with all tax opinions with respect to potentially material items that served as support for our tax accruals (including contingency accruals or their absence and determinations of interest and penalty applicability), as well as any tax opinions that contradicted, or provided lower levels of assurance than, the options ultimately used to support our tax positions.

#### **L. Use of the Work of a Specialist**

1. We agree with the findings of the specialists that we engaged to evaluate the pension funds, the derivatives and the ad-hoc evaluation of asset lives have adequately considered the qualifications of the specialists in determining the amounts and disclosures included in the financial statements and the underlying accounting records. We did not give or cause any instructions to be given to the specialists with respect to the values or amounts derived in an attempt to bias their work, and we are not otherwise aware of any matters that have had an effect on the independence or objectivity of the specialists.

#### **M. Estimates**

1. We believe that the measurement processes, including related assumptions and models, used to determine the accounting estimates included in the financial statements have been consistently applied and are appropriate in the context of International Financial Reporting Standards as adopted by the European Union.
2. We confirm that the significant assumptions used in making the accounting estimates appropriately reflect our intent and ability to carry out the courses of action on behalf of the entity.
3. We confirm that the disclosures made in the financial statements with respect to the accounting estimates are complete and made in accordance with International Financial Reporting Standards as adopted by the European Union.
4. We confirm that no adjustments are required to the accounting estimates and disclosures in the financial statements due to subsequent events.

## **N. Retirement benefits**

1. On the basis of the process established by us and having made appropriate enquiries, we are satisfied that the actuarial assumptions underlying the scheme liabilities are consistent with our knowledge of the business. All significant retirement benefits and all settlements and curtailments have been identified and properly accounted for.

## **O. Valuation of goodwill**

1. The directors are of the view that the goodwill value of £51m in the company is supported by expectations of its future performance of the combined Bournemouth and South West Water businesses held and no impairment is required. Valuation is assessed on the RCV of the combined Bournemouth and South West Water businesses, applying a premium deemed to be appropriate based on businesses in a similar industry as at 31 March, 2017.

Yours sincerely



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Dr. Stephen Bird  
Managing Director



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Karen Senior  
Company Secretary