

SOUTHERN WATER CAPITAL LIMITED

**DIRECTORS' REPORT
AND ACCOUNTS FOR THE YEAR ENDED
31 MARCH 2007
Registered Number 04608528**

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SOUTHERN WATER CAPITAL LIMITED

Directors' Report and Accounts for the year ended

31 March 2007

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SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW

Southern Water Capital is the ultimate parent company of the Southern Water group of companies

As at 1 April 2006, Southern Water Capital owned 75% of the share capital of Southern Water Investments Ltd ("SWIL") The remaining 25% was owned by Veolia Water Investment Limited ("VWIL") Southern Water Capital acquired VWIL's entire shareholding on 10 April 2006

The principal operating company in the group is Southern Water Services Limited ("SWS") and the information contained in this Operating and Financial Review ("OFR") is therefore mainly based upon the activities of this company only Sections 1 and 2 that follow contain reviews of Southern Water Capital Limited and Southern Water Services Limited respectively

1) SOUTHERN WATER CAPITAL LIMITED

A THE BUSINESS

Non-regulated activities

In addition to the activities of SWS (see section 2), the Southern Water Capital group ("SWC group") holds an investment of 25% in Folkestone and Dover Water Services Limited

Financial KPIs

Under the SWC group financial structure, there are a comprehensive set of covenanted financial ratios but there are three key ratios, namely the ratio of consolidated net debt to Regulatory Capital Value (RCV), the ratio of cash income to consolidated net interest cost and the ratio of cash income less Current Cost Depreciation and Infrastructure Renewals Charge to consolidated net interest cost

The net debt used in the net debt RCV ratio is calculated as consolidated short and long-term borrowings less cash and short-term deposits The RCV is set by Ofwat for five year periods at periodic reviews and reflects forecast growth in the asset base It is adjusted at each periodic review for any out-performance, shortfalls in outputs or permitted additional investment and for certain asset disposals The ratio of consolidated net debt to RCV for the SWC group is targeted to be maintained at below 90%, in line with debt covenants in the new £175m term facility

Senior cash interest cover (measured as net cash flow to consolidated senior debt interest) is targeted to be maintained above 2 times to meet covenanted levels

Senior adjusted cash interest cover (measured as net cash flow less Current Cost Depreciation and the Infrastructure Renewals Charge, to consolidated senior debt interest) is targeted to be maintained above 1.0 times, to meet covenanted levels

Net debt. RCV

| | |
|--------------------------|-------|
| 2006-07 performance | 82.9% |
| Covenanted lock-up level | <90% |

Senior cash interest cover

| | |
|--------------------------|------------|
| 2006-07 performance | 3.08 times |
| Covenanted trigger level | 2.0 times |

Adjusted senior cash interest cover

| | |
|--------------------------|------------|
| 2006-07 performance | 1.20 times |
| Covenanted lock-up level | 1.00 times |

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

1) SOUTHERN WATER CAPITAL LIMITED (continued)

B. FINANCIAL PERFORMANCE

Financial Performance

The accounting policies of the group, including any changes in accounting policies in the year, are set out on page 31

Consolidated profit and loss account

The consolidated profit and loss account of Southern Water Capital Limited is summarised in Table 1

| Table 1 | 2007 | 2006 | Change |
|---|---------|---------|---------|
| | £m | £m | % |
| Turnover | 575.8 | 541.5 | 6.3 |
| Cost of sales and admin expenses ¹ | (340.7) | (315.8) | 7.9 |
| Exceptional items | (25.0) | (8.4) | 197.6 |
| Other income | 1.6 | 2.5 | (36.0) |
| Operating profit | 211.7 | 219.8 | (3.7) |
| Disposal of fixed assets | 19.2 | 8.6 | 123.3 |
| Net interest | (183.2) | (173.2) | 5.8 |
| Profit before tax | 47.7 | 55.2 | (13.6) |
| Tax | (17.1) | (20.4) | (16.2) |
| Profit after tax | 30.6 | 34.8 | (12.1) |
| Equity minority interests | - | (8.4) | (100.0) |
| Dividends | - | (10.0) | (100.0) |
| Retained profit | 30.6 | 16.4 | 86.6 |

Notes 1 Excludes exceptional items

Operating profit for 2006-07 decreased by 3.7% to £211.7m. This decrease results principally from the provision for a fine to be imposed by the regulator, OFWAT, for the historical failure to meet customer service standards and the misreporting of customer services data. This has been offset to a degree by the impact of inflation and the K factor on the group's turnover, which rose by 6.3% to £575.8m.

Costs, excluding exceptionals, increased by 7.9% to £340.7m. This increase resulted mainly from higher electricity prices and the impact of inflation, offset by operating efficiencies. The exceptional items of £25.0m in 2006-07 and £8.4m in 2005-06 relate to the regulatory fine as described above and the costs of the customer services investigation respectively (as discussed in Section 2H).

The increase in profit on disposals of £19.2m (2005-06 £8.6m) relates mainly to the sale and leaseback of the head office.

The profit after taxation for the year amounted to £30.6m (2006 £34.8m). No interim dividends were paid during the year (2005-06 £0.25 per ordinary share). At the year end a final dividend for 2007 had not been approved by the Board of Directors.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

1) SOUTHERN WATER CAPITAL LIMITED (continued)

B FINANCIAL PERFORMANCE (continued)

Cash flow

Net cash inflow from operating activities increased to £343.7m for 2006-07 from £335.6m in 2005-06. This reflects the impact of increased turnover, offset by an increase in debtors and accruals.

The net cash outflow from returns on investment and servicing of finance decreased to £42.7m for 2006-07 from £167.3m in 2005-06. This is due to the timing of interest payments around the year end – interest of £98.2m was paid on 2nd April 2007.

There was a significant increase in outflow of cash relating to the purchase of tangible fixed assets of £505.3m (2005-06: £272.5m) and a net cash outflow before financing in 2006-07 of £468.5m (2005-06: £90.6m) primarily due to the purchase of the minority interest (25%) stake in SWIL. During the year, bonds of £200m and loan notes of £124m were issued, and a term loan of £175m was taken out, in order to help meet the ongoing requirements of the capital investment programme and to finance the acquisition of the minority interest in SWIL.

Balance sheet

At the end of the period to 31 March 2007, the group had fixed assets of £3,590.1m (2005-06: £3,151.1m) an increase of £439.0m from March 2006. This increase results from the large capital investment programme in SWS and a revaluation of fixed assets during the year as a result of the acquisition of the minority interest in SWIL.

In order to fund the ongoing capital investment programme in SWS and finance the purchase of the minority interest in SWIL, additional borrowings were used. As a result, creditors over one year increased by £276.0m from £2,796.9m to £3,072.9m.

Overall net assets increased by £105.0m from £18.5m to £123.5m.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED

A THE BUSINESS

Southern Water Services Limited ("SWS") holds an appointment as a water and sewerage undertaker for the South East area of England. Drinking water supplies and wastewater services are provided in an area covering Kent, Sussex, Hampshire and the Isle of Wight. These activities, which are referred to as the appointed business, account for 99% of turnover. There are also a number of minor activities which are not regulated under the appointment and which are described here as the non-appointed activities.

Water services

SWS supplies high quality drinking water to more than 1 million customers across the region, through a network of approximately 14,000 km of mains, 94 water treatment works and numerous pumping stations and service reservoirs.

The average daily volume supplied in 2006-07 was 489 million litres a day. Of the 938,000 households served, 33% have a meter and pay by reference to the amount of water supplied. 81% of business customers are metered.

Wastewater services

Domestic and trade wastewater services are provided to around 1.7 million domestic and business customers. During 2006-07, 370 wastewater treatment works treated an average of 758 million litres of wastewater every day, delivered by a network of more than 21,000km of sewers.

Around 1 million of these customers are also provided with water services by SWS, the remainder receive their supply from one of the small water companies which hold appointments for water supply only within the region.

Of the total water and wastewater services turnover, 19% is derived from commercial customers whilst the remainder is from households.

Non-appointed activities

SWS also carries out a small number of non-appointed activities associated with the core business. The largest of these is the provision of property search information for homebuyers. During the year almost 80,000 searches were sold. The full implementation of Home Improvement Packs is likely to lead to an increase in demand for this service in future.

During the year a number of non-appointed business areas were sold or in the process of being sold, including the provision of leisure facilities at Bewl Water, the largest reservoir in the region, and the provision of aerial mast sites at treatment works and other company sites. This has enabled the business to focus on delivering the best services for water and sewerage customers.

Regulation of the water industry

The Water Services Regulation Authority (WSRA) replaced the office of the Director General of Water Services on 1 April 2006. However, the WSRA has continued to operate under the organisation's former name 'Ofwat'.

Ofwat's main duties are ensuring companies can finance their functions, protecting customers' interests and promoting competition. It is also responsible for setting price limits for all appointed water and sewerage undertakers. These price limits apply to the weighted average of water and wastewater charges.

Price limits were last set in 2004 for the period 2005-06 to 2009-10. The allowed increases are shown in Figure 1. Associated with these price limits are a set of required outputs and efficiency targets. Price limits for the subsequent five-year period will be set in 2009. Preparations for the 2009 periodic review have already begun, and more details are set out below.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

A. THE BUSINESS (continued)

Regulation of the water industry (continued)

Figure 1. Price limits

| | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 |
|-------------------------------|---------|---------|---------|---------|---------|
| Allowed increase ('K' factor) | 12.6% | 3.9% | 3.5% | 5.8% | 2.6% |

Charges can be increased by RPI plus the 'K' factor

Competition

The Water Act 2003 set out a framework for the development of competition within the water industry. The Act allows for the licensing of water suppliers who can provide either retail services only, or use incumbent companies' networks for the delivery of water supplies to their own customers.

Under this regime currently only water customers consuming more than 50 million litres of water a year can switch supplier. To date, no customers of any incumbent water undertaker have switched supplier. Ofwat is reviewing the framework for competition in conjunction with Ministers.

Competition is also possible through cross-border supplies and inset appointments, where the incumbent's licensed area of supply is altered. Competition from these areas has been limited to date with only 11 inset appointments in the industry, none in SWS's supply area.

Despite this slow progress to date, the development of greater competition in the sector is expected to be a key feature of the next few years.

Strategic Goals

SWS is committed to delivering excellent service to its customers while safeguarding the environment and delivering returns to shareholders which reflect the risks of the business. The Board's strategy to achieve this is to focus tightly on the core activities, utilising professional partner companies to provide non-core support in areas such as IT and finance.

To support this strategy the Board has endorsed a comprehensive set of performance targets for all areas of the business to ensure that regulatory goals are met and that the business delivers for customers effectively and efficiently.

In addition, to ensure focus on key issues, the Top 10 targets for the organisation are set out annually for all staff. These are the areas where improvements are required, such as minimising pollution incidents and where focus needs to be maintained, such as Health & Safety.

The Top 10 targets for the coming year are set out below.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

A. THE BUSINESS (continued)

1. Minimising compliance failures at wastewater treatment works
2. Minimising pollution incidents, particularly those in the most serious categories 1 and 2
3. Ensuring security of water supplies by achieving the maximum level on Ofwat's Security of Supply Index and maintaining our low leakage levels
4. Improving the quality of drinking water supplies on at least two key parameters
5. Delivering the capital programme investment and outputs in line with the business plan profile
6. Meeting the targets in Phase 2 of the Customer Services Ofwat Monitoring Plan
7. Delivering customer service improvements by reducing customers' need to contact the company
8. Commence a project to deliver a new Business Application Suite to improve the efficiency of finance, procurement and human resources functions
9. Fully deploying new "Front Office" systems for field operatives
10. Reducing further the number of incidents reportable to the HSE and accidents leading to time off work

Headline KPIs

The Top 10 targets are supported by a series of sub-targets and Key Performance Indicators (KPIs) for the organisation. These KPIs are the indicators which the Board regularly monitors and considers key to the achievement of its long-term objectives for the organisation as a whole.

Financial KPIs

Under the financial structure, there are a comprehensive set of covenanted financial ratios but there are two key ratios, namely the ratio of net debt to Regulatory Capital Value (RCV) and the ratio of cash income to net interest cost.

The net debt used in the net debt RCV ratio is calculated from SWS's Regulatory Accounts as short and long-term borrowings less cash and short-term deposits. The RCV is set by Ofwat for five year periods at periodic reviews and reflects forecast growth in the asset base. It is adjusted at each periodic review for any out-performance, shortfalls in outputs or permitted additional investment and for certain asset disposals. The ratio of senior (Class A and B) debt to RCV is targeted to be maintained at below 85%, in line with our debt covenants.

Senior adjusted cash interest cover (measured as net cash flow less Current Cost Depreciation and the Infrastructure Renewals Charge, to senior debt interest) is targeted to be maintained above 1.1 times, to meet covenanted levels.

Net debt RCV

| | |
|--------------------------|------|
| 2005-06 performance | 76% |
| 2006-07 performance | 78% |
| Covenanted lock-up level | <85% |

Senior cash interest cover

| | |
|--------------------------|-----------|
| 2005-06 performance | 1.3 times |
| 2006-07 performance | 1.3 times |
| Covenanted trigger level | 1.1 times |

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

A. THE BUSINESS (continued)

Customer services

Ofwat has specified a range of customer service indicators which it monitors and reports on each year. The Board pays particular attention to these indicators and SWS's comparative performance.

However, given the difficulties experienced in the customer service area over the last two years (described in Section H below), the Board is now focused on delivering the customer services improvement plan to be agreed with Ofwat. This plan covers each of the Ofwat customer service indicators – response to billing enquiries and complaints, telephone call response times and satisfaction and meter reading.

Overall performance across all areas of the business is measured by Ofwat using an Overall Performance Assessment (OPA) index, which takes in a range of measures including customer service, service interruptions, water pressure, leakage, pollution incidents and so on. Price limits can be adjusted for comparatively good or poor performance on the OPA index at price reviews. The OPA score has been adversely affected by the customer service issues over the last two years. Nonetheless, the Board continues to monitor performance against this overall measure and aims to achieve an incremental improvement in the score each year. For 2005-06 the OPA score was 360 out of a maximum of 437.5 points. 2006-07 figures have not yet been published by Ofwat, but an estimate has been given.

Customer services

2007-08 target

Achievement of agreed improvement plan

Overall Performance Assessment

| | |
|---------------------|------------------------|
| 2005-06 performance | 360 points |
| 2006-07 performance | 341 points (estimated) |
| 2007-08 target | 398 points |

Water services

The provision of high quality drinking water is fundamental to public health. The Drinking Water Inspectorate (DWI) oversees standards of drinking water in England & Wales and SWS is required to monitor water quality at its water treatment works, reservoirs and at customer taps. The overall DWI measure of tests meeting the standards at customer taps is reported as percentage mean zonal compliance and is measured over the calendar year. This is the key measure of the quality of water received by customers. Maintaining mean zonal compliance as close to 100% as practicable is a key target to ensure consistently high standards for customers.

Minimising leakage is a key component of the strategy to ensure adequacy of water resources. It is also an issue which customers care deeply about. SWS's aim is to beat annual leakage targets set by Ofwat (92 MI/d for 2006-07 and 2007-08) maintaining its position as the water and sewerage company with the lowest leakage levels¹ in the industry.

Drinking water compliance

| | |
|------------------|--------|
| 2005 performance | 99.96% |
| 2006 performance | 99.95% |
| 2007 target | 99.97% |

Leakage

| | |
|---------------------|----------|
| 2005-06 performance | 93 MI/d |
| 2006-07 performance | 82 MI/d |
| 2007-08 target | <92 MI/d |

¹ Measured on a per property basis

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

A THE BUSINESS (continued)

Water services (continued)

Wastewater services

Wastewater activities can have a significant effect on the natural environment. SWS's goal is to minimise that impact by ensuring that any pollution incidents are kept to a minimum and by ensuring that wastewater treatment works comply with the discharge consents issued by the Environment Agency. Consent compliance is measured in terms of the equivalent population served by failing works in order to reflect the impact of failures. The key target is compliance with look-up table consents (which represent the vast majority of current consents).

Pollution incidents at sewage-related premises

| | |
|---------------------|---|
| 2005-06 performance | 16 Category 1 & 2 pollution incidents 200 Category 3 incidents |
| 2006-07 performance | 15 Category 1 & 2 pollution incidents 312 Category 3 incidents |
| 2007-08 target | 10 Category 1 & 2 pollution incidents 180 Category 3 incidents |

Wastewater treatment works compliance

| | |
|---------------------|-----------------------------|
| 2005-06 performance | <0.1% equivalent population |
| 2006-07 performance | 1.4% equivalent population |
| 2007-08 target | 0.1% equivalent population |

Business re-organisation

SWS's strategy is to focus tightly on its core activities using professional service providers to support these activities. As part of this strategy a series of Master Framework Agreements (MFAs) have been entered into with service providers. MFAs have been signed for the provision of Engineering services (with TCS and Atkins), General Services (Wipro and TCS) and Customer Services (RR Donnelley). Under the MFA, individual work-packs are let for discrete activities, with eight work-packs having been let to date for the provision of services. These work-packs cover a diverse range of activities from Network Development services under the Engineering framework to finance and human resources administration under the General Services agreement.

A number of staff have transferred to service providers as work packs have been let. No SWS staff have been made redundant but a number have been freed up to move into front-line customer-focused positions. Further work-packs will be let under the framework agreements to ensure that SWS staff are clearly focused on providing excellent services to customers.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

B. FINANCIAL PERFORMANCE

The review of financial performance has been taken directly from the published accounts of SWS, which excluded the provision for the fine from Ofwat, since at the time of signing the SWS accounts, management did not have a good enough basis on which to make an estimate of the provision. In the SWS accounts the fine has been included as a contingent liability.

Profit and loss account

The profit and loss account of SWS is summarised in Table 1

| Table 1 | 2007 | 2006 | Change |
|---|---------|---------|---------|
| | £m | £m | % |
| Turnover | 575.8 | 541.5 | 6.3 |
| Cost of sales and admin expenses ¹ | (332.2) | (314.0) | 5.8 |
| Exceptional items | - | (14.1) | (100.0) |
| Other income | 1.0 | 1.7 | (41.2) |
| Operating profit | 244.6 | 215.1 | 13.7 |
| Disposal of fixed assets | 20.2 | 5.0 | 304.0 |
| Net interest | (129.4) | (126.1) | 2.6 |
| Profit before tax | 135.4 | 94.0 | 44.0 |
| Tax | (41.3) | (32.6) | 26.7 |
| Profit after tax | 94.1 | 61.4 | 53.3 |
| Dividends | (61.8) | (44.8) | 37.9 |
| Retained profit | 32.3 | 16.6 | 94.6 |

Notes 1 Excludes exceptional items

Operating profit for 2006-07 increased by 13.7% to £244.6m. This increase results principally from the impact of inflation and the K factor on the company's turnover, which rose by 6.3% to £575.8m. This increase was required to secure and service the ongoing finance for the capital investment programme.

Costs, excluding exceptionals, increased by 5.8% to £332.2m. This increase resulted mainly from higher electricity prices and the impact of inflation, offset by operating efficiencies. The exceptional item of £14.1m in 2005-06 relates to the costs of the customer services investigation (discussed in Section H). The increased profit before tax also reflects an increase in profit from asset sales. The profit on disposals of £20.2m (2005-06 £5.0m) relates mainly to the sale and leaseback of the head office.

The profit after taxation for the year amounted to £94.1m (2006 £61.4m). In the prior year the directors recommended a final dividend of £89.29 per ordinary share, which was paid in the current financial year. Interim dividends of £1,014.39 per ordinary share (2006 £710.80 per share), totalling £56.8m were also paid during the year, resulting in total dividends paid and charged in the current financial year of £61.8m. At the year end the final dividend for 2007 had not been approved by the Board of Directors.

Net cash inflow from operating activities increased to £339.7m for 2006-07 from £331.6m in 2005-06. This reflects the impact of increased turnover, offset by an increase in debtors and accruals.

The net cash outflow from returns on investment and servicing of finance decreased to £79.4m for 2006-07 from £106.7m in 2005-06, due to lower interest paid and the timing of interest payments at the year end.

There was a significant increase in outflow of cash relating to the purchase of tangible fixed assets of £505.3m (2005-06 £272.4m) and a net cash outflow before financing in 2006-07 of £305.5m (2005-06 £90.1m). During the year bonds of £200m were issued in order to help meet the ongoing requirements of

SOUTHERN WATER CAPITAL LIMITED

the capital investment programme
OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

B FINANCIAL PERFORMANCE (continued)

Balance sheet

At the end of the period to 31 March 2007, SWS had fixed assets of £3,319.5m (2005-06 £2,952.9m) an increase of £366.6m from March 2006. This increase results from the large capital investment programme. Overall net assets increased from £729.8m to £781.3m.

Regulatory Accounts

Under the terms of its appointment as a water and sewerage undertaker SWS is also required to produce a set of regulatory accounts, for the appointed business only, on a current cost basis. These are discussed below.

Current cost profit and loss account (appointed business)

| Table 2 | 2007 | 2006 | Change |
|------------------------------|---------|---------|--------|
| | £m | £m | % |
| Turnover | 566.8 | 533.9 | 6.2 |
| Current cost operating costs | (390.3) | (376.6) | 3.6 |
| Operating income | 10.0 | 4.9 | 104.1 |
| Working capital adjustment | 4.5 | 0.7 | 542.9 |
| Operating profit | 191.0 | 162.9 | 17.2 |
| Other income | 0.2 | 0.4 | (50.0) |
| Financing adjustment | 97.2 | 46.6 | 108.6 |
| Net interest | (129.4) | (126.1) | 2.6 |
| Profit before tax | 159.0 | 83.8 | 89.7 |
| Tax | (40.2) | (31.3) | 28.4 |
| Profit after tax | 118.8 | 52.5 | 126.3 |
| Dividends | (59.1) | (41.8) | 41.4 |
| Retained profit | 59.7 | 10.7 | 457.9 |

Turnover of the appointed water and sewerage business increased by 6.2% or £32.9m. This increase reflects the allowed price increase of 6.33%. Whilst the majority of customers are not charged according to the volume consumed, the drought which was experienced in the south east region during 2005 and 2006 has had a negative effect on measured water sales.

Compared to the assumptions underlying Ofwat's price limits, turnover was lower than forecast. This results principally from lower water and wastewater sales to metered customers as a result of the drought. It also reflects the rate of switching from an unmetered to a metered charge basis and the assumptions made by Ofwat about the demand of customers switching to a meter.

Total operating costs increased by 3.6% to £390.3m. Within this, operating expenditure, excluding exceptionals, grew by £15.6m. The largest cost increase was power, reflecting the increase in electricity tariffs. Increased leakage detection activity and additional costs to improve customer service performance also increased operating expenditure.

Current cost depreciation (CCD) increased by £10.4m to £163.1m and the infrastructure renewals charges (IRC) increased by £2.1m to £41.5m, reflecting the increased level of capital investment in the current period.

Operating income includes current cost profit on the disposal of fixed assets. This disposal profit is lower than the figure shown in the statutory accounts, due to the different accounting basis and the disposal of some assets outside of the appointed business.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

B. FINANCIAL PERFORMANCE (continued)

Current cost profit and loss account (appointed business) (continued)

The increase in profit before tax is also affected by the significant increase in the current cost financing adjustment of £97.2m (2005-06 £46.6m), as a result of higher inflation levels during the year

Retained profit of £59.7m has been transferred to reserves

Current cost cashflow (appointed business)

| Table 3 | 2007 £m | 2006 £m | Change % |
|---|------------|------------|-------------|
| Net cashflow from operating activities | 335.8 | 327.3 | 2.6 |
| Net cashflow on investment and servicing of finance | (77.8) | (98.1) | (20.7) |
| Taxation | (16.0) | (15.8) | 1.3 |
| Net cashflow from investing activities | (486.9) | (253.1) | 92.4 |
| Equity dividends paid | (59.0) | (41.8) | 41.1 |
| Net cashflow before financing | (303.9) | (81.5) | 272.9 |
| Net cashflow inflow from financing | 196.9 | 70.9 | 177.7 |
| Increase/decrease in cash in the year | (107.0) | (10.6) | 909.4 |

Net cash flow from operating activities increased to £335.8m for 2006-07 from £327.3m in 2005-06. Net cashflow from investing activities increased from £253.1m to £486.9m. This reflects the significant increase in the capital investment programme during 2006-07. As a result net cash outflow before financing rose to £303.9m in 2006-07 (2005-06 £81.5m).

Current cost balance sheet (appointed business)

At the end of the period to 31 March 2007, SWS had current cost fixed assets of £14,917m (2005-06 £13,975m) an increase of £942m from March 2006. This increase results from the effects of inflation and the large capital investment programme. Overall net assets increased from £11,856m to £12,504m.

Net debt at the year end, as per the regulatory accounts and including preference shares and mezzanine debt, was £2,749.9m (2005-06 £2,412.3m). The net debt to RCV ratio, a key performance indicator for the company and Ofwat on the above basis, reduced from 96% to 94%.

The Regulatory Capital Value, the capital value used by Ofwat for price setting purposes, was £2,914m at March 2007.

Dividend policy

SWS's dividend policy is to pay a dividend that is consistent with Condition K of the regulatory operating licence, to reward equity holders in accordance with the risks of the business and to pay a sustainable dividend reflecting regulatory out-performance, non-appointed profit and asset sales. The increase in dividends paid in 2006-07 reflected the cashflow from the sale of income rights relating to aerial masts.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

C. CAPITAL STRUCTURE, LIQUIDITY AND OTHER FINANCIAL MATTERS

Capital structure and borrowing covenants

SWS carried out a refinancing of its regulated business in 2003 with the aim of reducing its cost of capital through a substantial increase in the proportion of debt finance. As a proportion of its RCV, net debt, including preference shares, is now 94%.

At the same time a Common Terms Agreement (the CTA) between the members of the SWS Financing Group² and its debt investors was entered into. The CTA sets out the arrangements for the ongoing management of SWS's debt issuance programme, including a set of financial covenants, trigger events and events of default.

Interest rate, liquidity and cash management risk

SWS hedges its exposure to interest rate risk on at least 85% of its outstanding debt liabilities in respect of Class A and Class B debt for the period to the next Periodic review and at least 70% in the next period (on a rolling basis) into either index-linked or fixed rate obligations.

Additional funds are raised as required, to ensure that sufficient cash and/or facilities are available to fund the business for the next twelve months.

The Company sets exposure limits for, and deposits cash balances with, organisations whose credit ratings are rated a minimum of Moody's P1, Standard & Poor A1 or Fitch F1.

The regulatory framework, under which revenues and the RCV are indexed, exposes SWS to inflation risk. This risk is managed through the use of index-linked instruments within the overall debt portfolio.

An analysis of net debt is included in Note 22 to the accounts.

Credit risk

81% of the water and wastewater services revenue is received from household customers. The 1999 Water Act prohibits the disconnection of domestic customers for failure to pay water and sewerage charges. An extensive range of collection and recovery methods are employed, as appropriate to the individual circumstances of the customer, to minimise the risk of non-payment. For non-domestic customers, the right to disconnect supplies for non-payment remains and is exercised as appropriate.

The level of provision against non-collection of charges is reviewed on an annual basis, based on the age profile of the debt and the likelihood of recovery. A material increase in uncollected revenue, compared to that assumed in the setting of price limits, may provide grounds for an interim determination of K by Ofwat.

² The Southern Water Financing Group consists of Southern Water Services Ltd, Southern Water Services (Finance) Ltd, SWS Holdings Ltd, SWS Group Holdings Ltd,

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

D. OPERATIONAL PERFORMANCE

Water services

Hosepipe bans, which had been imposed in Sussex, Kent and the Isle of Wight, were lifted in January 2007. This followed winter rainfall which was closer to normal levels, after two consecutive dry winters, along with investment to produce additional supplies and reduce leakage to record low levels. Further restrictions in 2007 are now unlikely. Regulatory planning assumptions underpinning water resources investment continue to be discussed with Ofwat and the Environment Agency. The longer-term view of the company is that planning should be on the basis that no restrictions should be necessary until three dry winters have been experienced.

Drinking water quality continued to be high across the region. Mean zonal compliance, based on compliance at the customer tap with DWI standards, remained high at 99.95% for the 2006 calendar year. To maintain these high standards each year over 600,000 tests are carried out on water from its source to the customer's tap. Drinking water supply operations are accredited to ISO 9001 standards. Over the current price limit period further capital investment will be made in order to reduce turbidity (cloudiness) at four sources and reduce nitrate concentrations at a further three groundwater sources.

Environmental

SWS recognises that its activities have an effect on the natural environment, through the abstraction of water for supply and the discharge of treated effluent to water courses and the marine environment. Both abstraction and effluent discharges are regulated by the Environment Agency via abstraction licences and discharge consents.

During the 2006 calendar year compliance with Water Resources Act "look-up table" discharge consents (which represent the vast majority of current consents) was 98.6% based on the equivalent population served by each works.

Pollution incidents occur mainly as a result of failures in the sewerage network. Incidents are classified as Category 1, 2 or 3 by the Environment Agency with categories 1 and 2 representing the most serious incidents. Whilst SWS always works hard to avoid any incidents occurring, the nature of wastewater operations and the extent of the sewerage network mean that some incidents are inevitable. SWS has an incident response team on standby to ensure that where incidents do occur, their impact on the environment is minimised.

Minimising the number of pollution incidents and ensuring compliance with discharge consents are both 'Top 10' targets for 2007-08.

Bathing water quality

During the 2006 bathing water season (1st May to 30th September) the Environment Agency tested 79 beaches in the region for compliance with the EU Bathing Water Directive standards. For the second year running all 79 beaches met the mandatory standards. 78% met the much stricter guideline standards in 2006.

Customer service

Following the customer service irregularities uncovered in 2005, a plan to recover customer service performance was agreed with Ofwat. The opportunity has been taken to review all customer service operations and much transactional work such as updating account details has been off-shored. This will allow SWS staff to focus on continuing to raise customer service standards.

In February, a new customer billing and contact system was delivered for the company's 1.8 million water and sewerage customers, based on the state-of-the-art SAP-ISU platform. This replaced a 15-year old mainframe system which was no longer supported and had limited functionality. Whilst some teething problems have been experienced in the first few months of operation, giving rise to increased call volumes, the system is bedding in and productivity is beginning to improve.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

D. OPERATIONAL PERFORMANCE (continued)

Energy use

SWS is committed to exploring opportunities to minimise its impact on the environment and one of the key ways this can be done is by constantly looking at ways to reduce energy use and increase the proportion of renewable energy used at treatment works. SWS has been awarded Energy Efficiency Accreditation by the Carbon Trust, which recognises achievements in reducing energy use.

Six Combined Heat and Power plants (CHP), which utilise methane produced at wastewater treatment works, are now in operation. These units recycle the surplus green energy back into the national grid, to help bring green power to everyone. During 2006-07 over 10 megawatt hours of electricity were produced from CHP.

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

E. LOOKING AHEAD

The remainder of AMP4

2007-08 is the third year of the current five year regulatory period (AMP4)

In the first two years of AMP4, £834m of the £1.8bn capital expenditure programme for this regulatory period has been delivered and many of the required outputs have been delivered ahead of schedule. This is a considerable achievement and is likely to put the company in an industry-leading position in this respect. However, challenges remain to deliver the remainder of the programme.

The largest scheme in this programme is the provision of a new wastewater treatment works to provide secondary treatment for Brighton & Hove. This scheme is needed to ensure that the effluent discharges meet the requirements of the Urban Wastewater Directive. A decision on the proposed scheme has recently been received from the Secretary of State, following a five-week planning enquiry held in the summer of 2006. It supported the scheme and endorsed the selection of the site at Peacehaven, but refused planning permission due to visual and landscape impact. A new proposal is currently being developed.

The second major objective for AMP4 is to ensure stable 'serviceability' is achieved on above ground wastewater assets by 2007-08. Serviceability is assessed on the basis of wastewater treatment works compliance. Improving compliance is one of the top ten targets for 2007-08 and SWS remains confident that it will achieve a stable serviceability assessment.

On the water service side, the achievement of a maximum score of 100 on Ofwat's security of supply index – a measure of the resilience of our water supplies – is being targeted by 2008-09.

At the same time the demanding efficiency savings required by the 2004 price limits must be delivered.

The framework contracts which have been let with service providers for non-core and engineering services, and the continuing engagement of all staff will be crucial to achieving these efficiency savings and meeting the required regulatory outputs.

The 2009 periodic review

2007-08 also sees the beginning of the process for Ofwat's 2009 periodic review of price limits for the period from 2010 to 2015 (AMP5). Work is already underway to identify the investment requirements for the period and with the benefit of extensive customer research, to understand customers' priorities.

Later this year, as the first milestone in the price review, a Strategic Direction Statement will be published, setting out a 25-year vision, reflecting customers' views on the standards they expect from SWS and the company's delivery plans.

Climate change will inevitably be a key influencing factor in this strategy going forward. The effect on the availability of water resources and the risk of sewer flooding from less predictable weather patterns, represent a significant challenge for the company. Carbon emission considerations will be fully incorporated into the planning process to ensure that the environmental impacts are at the heart of the decision-making processes for the review.

The key investment driver for AMP5 will be meeting the requirements of the Water Framework Directive (WFD). This requires the achievement by 2015 of "good chemical and ecological status" for surface waters and "good" status for groundwater in terms of quality and quantity. This is to be achieved through the establishment of River Basin Management Programmes, the first of which will run consecutively with AMP5. Further investment in water resources will also be required to ensure security of supply and further reduce the risk of flooding from sewers.

Overall, it is expected that the required capital investment programme will continue to be very substantial. Customers' willingness and ability to pay for these improvements will be a key issue for the review.

Work to extend the opportunities for competition for customers is also expected to be a major feature of the AMP5 period. The review of competition being carried out by Ofwat and Ministers will shed some light on the likely direction this will take. However, fundamental changes in the nature of competition in the industry are likely to require changes to the legislation.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

F. RESOURCES AND KEY RELATIONSHIPS

Management

The Board of SWS is responsible for the overall strategic direction of the business. During the year the Board consisted of three executive directors – the Chief Executive Officer, Finance and Corporate Strategy Directors – along with five non-executive directors. Three of these non-executive directors are independent, as required by our regulatory licence.

The day-to-day operations of the business are overseen by the Executive Management Team. This group, led by the Chief Executive Officer, consists of the heads of each department – Finance, IT, Human Resources, Operations, Assets, Customer Services, Corporate Strategy, Commercial, Legal and Communications.

People

At the year end, SWS had 1,784 full-time-equivalent staff (2005-06 1,922) across the region. Staff turnover was higher than normal, reflecting the transfer of a number of staff to service providers and the strategy to focus on core activities.

The importance of the role played by staff in driving the company performance is recognised by the Board and this year investment in training has been increased significantly. During the year a programme of Leadership conferences was run for staff at all levels within the organisation, designed to engage employees and come up with some business solutions which will help improve services to customers. A series of 'Toolkit' residential training weeks was also begun. These have been attended by 220 members of staff and are designed to ensure that all staff have the commercial understanding and business techniques required to manage in a rapidly changing environment.

Key partners

Capital programme partners

Much of the £1.8bn capital programme for this regulatory period will be delivered either through a series of Utility Service Contracts or a Single Entry Contract with 4D.

Utility Services Contractors – smaller schemes within the capital programme, with a total value of approximately £400m, are being delivered through SWS's key contractors Morrison Utility Services (mechanical & electrical maintenance and renewals), Clancy Docwra (water distribution system maintenance), Holleran, Mouchel Parkman (sewerage network schemes) and Viridor (waste management).

4D – a contract for the management, design and delivery of stand-alone construction projects for the AMP4 was let to 4D in 2005. 4D is a special purpose consortium comprising United Utilities, Costain, and Montgomery Watson Harza. Under the contract more than 270 schemes in the investment programme will be delivered.

The relationship with both 4D and the Utility Services Contractors has been important in meeting the AMP4 investment targets to date and will be crucial to the successful delivery of the remainder of the programme. In May 2007, the partnership with 4D was recognised with the award of the Partnership Initiative of the Year trophy at the Water Industry Achievement Awards.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

F. RESOURCES AND KEY RELATIONSHIPS (continued)

Capital programme partners (continued)

Other significant partners

Master Framework Agreements

During the year, SWS signed a series of Master Framework Agreements (MFAs) for the provision of services to the regulated business, in support of the Board's strategy of focussing on core activities. MFAs have been signed under three service areas – Customer Services, Engineering Services and General Services

Under the MFAs, individual work-packs are let for discrete activities, allowing the company to draw on expert service providers whilst simplifying the procurement and contract negotiation process and ensuring that a long-term partnership approach to the provision of services is achieved

Atkins and TCS have been signed as key partners under the Engineering MFA, whilst TCS and Wipro are the framework partners under the General Services MFA. To date, only RR Donnelley has been selected as a partner under the Customer Services MFA, although TCS have also been contracted to provide some back-office services within customer services. The Board is currently reviewing whether a second partnership agreement would be beneficial

These agreements and a successful partnership with these companies are key to delivery of the Board's strategy of providing excellent customer service by ensuring that focus on core activities, whilst also delivering against Ofwat's challenging efficiency targets

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

G. RISK MANAGEMENT

Risk management is embedded within SWS. A central database of key risks is maintained and all managers have access to and the ability to raise risks on the database. Risks are assessed in terms of impact in the following areas -

- financial
- reputation
- health and safety
- security of supply
- regulatory, environmental and legal

Creating clear visibility throughout the organisation of all key risks ensures that adequate controls are put in place or mitigating action taken to reduce the impact or likelihood of the risk manifesting. All risks within the database are assigned to a manager to ensure clear ownership of risks, and responsibility for their control and mitigation.

All risks scoring in the highest category are reviewed by the Chief Executive and all risks above a specified threshold are reviewed regularly by the Executive Management Team.

To ensure ongoing compliance with policies and standards of the company and regulatory and legal requirements, all senior managers are required to sign a six-monthly Letter of Compliance, certifying that the function for which they are responsible, complies with all relevant requirements.

Key risks

Regulatory risk

SWS is a highly regulated business. The water sector has three main regulators – Ofwat, the Environment Agency, and the Drinking Water Inspectorate. Not meeting any of the regulatory requirements or failing obligations placed upon the company by regulators could result in financial loss through the price setting mechanism, fines, legal enforcement action and ultimately the loss of the appointment as a water and sewerage undertaker. Any change in regulatory policy could also have a significant impact on the organisation.

The two most prominent examples of these risks currently are

The risk of a fine for historic customer service failures

Ofwat has given notice that it intends to impose fines for failures to achieve standards of customer service set out in the statutory Guaranteed Standards Scheme and mis-reporting of customer services data. It has the power to impose a fine of up to 10% of turnover in the most serious cases.

Ofwat's policy statement on financial penalties makes clear that in determining the level of any fine it will take account of a company's behaviour, the duration of the misdemeanour, the degree to which customers are affected and any other mitigating factors.

SWS has fully co-operated with Ofwat's investigation and customers have been reimbursed where it is found that they have suffered loss.

The risk of a poor determination at the 2009 periodic review

The process for Ofwat's 2009 periodic review begins in 2007-08. This will determine price limits for the period from 2010 to 2015. Failure to properly present a robust regulatory Business Plan may lead to a shortfall in funding for the regulatory period.

SWS has already begun investigatory work for the review and a dedicated project manager to manage the process has been appointed. To ensure that the industry's voice is heard as the methodology for the review is developed the company works closely with Water UK as well as maintaining its own close contact with regulators.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

G. RISK MANAGEMENT (continued)

Operational risk

Water and sewerage services are essential to public health and the safeguarding of the environment. Whether arising from a failure to maintain and invest in assets or operational issues, any failures could lead to interruptions to public water supplies, risk to health through supply of unfit water or severe environmental damage from the failure of our wastewater assets. These are ongoing risks which are managed as part of the everyday business. But the impact of failure is potentially significant for both customers and the environment.

The key risks in this area are currently

The risk of a further prolonged period of dry weather affecting the ability to maintain supplies

Exceptionally dry winters in 2004-05 and 2005-06 left the region's reservoirs and underground water resources at record low levels. A wetter winter in 2006-07 restored resources back to normal levels, and most reservoirs were more than 90% full by spring. However, there remains a residual risk that a repeat of the record low rainfall seen during the recent drought, and in particular three consecutive dry winters, would put at risk the ability to maintain supplies without restrictions.

This risk is managed by having a formal drought plan with trigger levels which escalate action. Longer-term SWS believes that the regulatory assumptions that underpin water resources planning need to be reviewed to ensure that no restrictions are necessary until three dry winters have been experienced.

The risk of not containing pollution incidents and works compliance targets not being met

SWS operates 373 wastewater treatment works and manages 21,000km of sewers across four counties. Whilst one of the key objectives for the company is to minimise the impact of its operations on the environment, the scale of these operations means that some incidents and compliance failures are inevitable. These can occur as a result of poor maintenance, human error or system incapacity.

As well as the risk of damage to the environment, such incidents can lead to prosecutions by the Environment Agency and fines being imposed as well as damage to the reputation of SWS. To minimise the risk of such incidents SWS is investing around £900m on asset maintenance over the current regulatory period. It also has a pollution incident response team on standby to ensure that where incidents do occur, their impact on the environment is minimised.

Financing risk

The Company intends to at least maintain its present risk profile, as measured by its investment grade credit rating. It does not enter into treasury transactions for the purpose of speculation, but only to manage risk inherent in the business or funding on a prudent basis.

Negative cashflows before financing, which have been a feature of the water industry since privatisation as a result of mandatory capital investment requirements, create an ongoing need to maintain access to the capital markets.

The risk of a significant increase in interest rates or closure of the capital markets to water companies in general

Any significant movement in interest rates or reduction in the availability of credit to the water industry might put at risk the company's ability to finance the future capital investment programme.

This risk is managed by ensuring that exposure to interest rate rises on current borrowings is hedged and accordingly 100% of current borrowings are at either fixed rates or index-linked. Good contacts with lenders, including bondholders, are maintained through an annual update programme with key investors.

A stable regulatory regime is vital to ensuring ongoing access and SWS works with the rest of the industry through Water UK to ensure that Ofwat appreciates the importance of this stability.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

G. RISK MANAGEMENT (continued)

Capital Investment

Over the current regulatory period a capital investment programme of £1.8bn is required to be delivered, the largest ever for SWS. An excellent start to the programme has been made and £834m has been delivered to date. However, around £1.0bn of capital investment must still be delivered before 2010.

Failure to deliver significant elements of the capital programme risks adjustments to the regulatory capital value at the next review, the risk of enforcement action by the Environment Agency, DWI or Ofwat and threats to the integrity of services.

Brighton & Hove secondary wastewater treatment scheme

The largest single scheme in the capital programme is provision of secondary sewage treatment for Brighton & Hove. Ofwat provided funding in the order of £200m in price limits for the scheme which involves the construction of a new wastewater treatment and sludge recycling works at Peacehaven, new pumping stations and underground sewers.

An enforcement notice has been served on SWS by the Environment Agency ("EA") requiring completion of the scheme by 31 March 2010.

Approval has been received by Brighton & Hove City Council for the elements of the scheme which fall within its jurisdiction. In relation to those parts of the scheme within East Sussex County Council's jurisdiction, a five-week long public inquiry was held last summer and a final decision was received on the 27 July 2007 refusing planning permission for the scheme due to visual and landscape impact, albeit supporting the need for the scheme and endorsing the selection of the site at Peacehaven.

The failure to achieve planning permission will mean that the enforcement notice issued by the EA cannot be met.

SWS is committed to completing the scheme as rapidly as possible and therefore a revised proposal is currently being developed incorporating as closely as possible all the mitigation recommended by the Secretaries of State and a new planning application will be submitted as soon as practically possible.

SWS have already undertaken considerable enabling works to allow us to move forward through construction as soon as planning permission is granted.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

H. CUSTOMER SERVICE GENERAL LEVELS OF PERFORMANCE

General Levels of Service

In October 2005, SWS brought to the attention of Ofwat certain inconsistencies relating to the reporting of response levels to, and handling of, customer enquires and complaints. These were discovered in the course of the Customer Services Transformation Project, which involved the installation of a new SAP-based billing system.

It became evident that as a result of these irregularities, some customers had not received compensation they were due under the statutory Guaranteed Standards Scheme (GSS) and data reported to Ofwat had been inaccurate. A specialist team was appointed jointly with Ofwat to investigate these irregularities and work was also instigated to make the payments due under the GSS. The matter was also reported to the Serious Fraud Office (SFO) by SWS.

SWS has fully co-operated with the investigation since discovery of the irregularities and taken significant steps to ensure that customers are reimbursed for any financial loss and that regulatory reporting and control systems are improved to avoid the risk of a re-occurrence.

To complement these system improvements, regulatory reporting has now been certified to ISO 9001 standard.

The company has been notified by Ofwat that it intends to impose a fine for the failures since April 2005. Consequently, a provision for £25.0m has been included in the accounts for the year ended 31 March 2007 (see note 17 of the consolidated accounts).

Customer services improvement plan

As a result of the investigation, it became evident that the actual customer service performance levels were well below those that had been historically reported to Ofwat and below the industry norms. In February 2006 an improvement plan was agreed with Ofwat to improve the levels of service provided to customers and bring them back into line with industry norms.

Regrettably, the first improvement plan agreed with Ofwat was not met. After significant improvements during the first half of the year initial teething problems with the new SAP billing system meant that performance declined materially in the second half of 2006-07. A second improvement plan, up to March 2008, is under review by Ofwat, to ensure that 'good' levels of performance, as defined by Ofwat in its annual customer service publications, are achieved. This will be achieved through increases in personnel, increased (offshore) back-office support, improvements to IT systems and productivity improvements as staff become accustomed to the new billing system and ongoing refinements are made to the system user interface.

SWS deeply regrets that it has not been providing customers with the level of service that they expect over the last few months and is determined to recover its position as rapidly as possible.

SOUTHERN WATER CAPITAL LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

2) SOUTHERN WATER SERVICES LIMITED (continued)

I. CORPORATE RESPONSIBILITY

Environmental policy

SWS is committed to meeting or improving upon legislative and regulatory environmental requirements and codes of practice, and aims to contain the environmental impact of its activities to a practicable minimum

Environmental performance is reported in an annual Sustainability Report. Responsibility for operating within a framework that supports sustainable development is fully recognised by SWS and where possible, targets for measurable indicators have been established. Performance against these targets is monitored and reported regularly.

Health & Safety

The Health and Safety of all employees, customers and contractors is of paramount importance.

Every employee receives a copy of the corporate policy statement on health and safety. There are regular meetings of employee representatives to consider all aspects of health and safety. During 2006-07 an 'Aim for Zero' campaign has been running to raise awareness of all employees' collective and individual responsibilities for the prevention of accidents. A Health and Safety Conference was also held, attended by 150 people, including SWS staff, contractors and guests.

The number of reportable accidents reduced further over that recorded for 2005-2006, highlighting the continuing improvement in health and safety at SWS. This achievement is supported by the award of a ninth successive year when we have been recognised in the RoSPA Occupational Safety Awards. This year a third consecutive Gold Medal - the highest category of general award - was awarded.

An internal occupational health service, including the provision of physiotherapy, is provided for all employees, along with a confidential guidance and counselling service. These services are continually being reviewed and developed to meet the changing needs of the business and employees at work.

Community programme

SWS plays an active role in the community under the company's Bringing Water to Life programme, supporting a series of community initiatives to build links and understanding with the communities served.

These initiatives are headlined by the long-running 'Learn to Swim' scheme for children between the ages of 4 and 12. Now in its 15th year of operation, the programme, supported by Olympic gold medallist Duncan Goodhew, has taught nearly 500,000 children to swim and was highly commended in the national Hollis Sponsorship Awards.

As part of an ongoing water efficiency campaign, an award-winning play and street theatre show featuring the wasteful Drip family is staged in schools and local events with the Facepack Theatre Company. In particular, "Are you a Drip?" and "Drips Ahoy" encourages water conservation for Key Stage 2 pupils. A range of educational resources for Key stages 1-4 is also provided, including a new online service.

SWS sponsors the local regions of Britain in Bloom and during 2006/7 ran a region-wide Schools in Bloom competition as part of this nationwide event. The company also agreed sponsorship of the Brighton Festival Children's Parade, one of the largest community events in the south of England.

Overseas, SWS is a long-standing supporter of the independent charity WaterAid, which works in regions such as Africa and Asia to help people gain improvements to their water, sanitation and hygiene. An annual customer appeal is run along with general fundraising activities and media publicity activities. During 2007 a record sum of almost £155,000 was raised for WaterAid from a James Bond-themed ball held for staff and SWS's key partner organisations. Further fundraising events, including a raceday and golf day, are planned for the current year.

To back the company's community support initiatives all employees are entitled to take two days paid leave each year to carry out community activities.

SOUTHERN WATER CAPITAL LIMITED

REPORT OF THE DIRECTORS OF SOUTHERN WATER CAPITAL LIMITED

The directors of Southern Water Capital Limited ("the company") present their report and the audited accounts for the year ended 31 March 2007

GROUP

As at 1 April 2006, the company owned 75% of the share capital of Southern Water Investments Limited ("SWIL"), the remaining 25% being held by Veolia Water Investments Limited ("VWIL"). On 10 April 2006 the company acquired VWIL's entire shareholding. The major subsidiaries included within the Group are shown in note 27.

PRINCIPAL ACTIVITIES OF THE COMPANY

The Company's principal activity is that of a holding company for SWIL and its subsidiaries.

PRINCIPAL ACTIVITIES OF THE GROUP

The principal activities of the Group are the provision of water supply and wastewater services in the south-east of England.

The trading results reflect the performance of the major trading subsidiary Southern Water Services Limited (SWS).

BUSINESS REVIEW

The information that fulfils the requirement of the business review can be found in the Operating and Financial Review (OFR) on pages 1 to 22, which are incorporated in this report by reference.

RESULTS AND DIVIDENDS

The profit and loss account on page 27 shows the Group's results, dividends and profit for the year. Further details are also available in the OFR on pages 1 to 22.

No dividends were paid in the year (2006 £10.0m).

POST BALANCE SHEET EVENTS

During June 2007, the owners of Southern Water Capital Limited indicated that they would be looking to dispose of their interest in the group and are actively seeking buyers.

On 5 July 2007, Royal Bank Investments Limited ("RBIL") acquired the entire shareholding of PPI Investments SP Inc and DE Shaw in SWC (representing 49% of the voting shares) increasing their shareholding to 97.9% of the voting shares.

In September 2007, the group was given confirmation of the regulator's intention to impose a fine for the historical failure to meet customer service standards and the misreporting of customer services data. Consequently, a provision of £25.0m has been included in the accounts to 31 March 2007.

DIRECTORS

The directors during the period were -

S Dance (resigned 5 July 2007)
D Workman
R Thian

SOUTHERN WATER CAPITAL LIMITED

REPORT OF THE DIRECTORS (continued)

RESEARCH AND DEVELOPMENT

The improvement of existing services and processes, together with the identification and development of new technology and solutions, are important aspects of the Group's strategy to enhance the quality of service to customers and improve methods of working. Research and development expenditure for the year amounted to £1.3m (2006: £1.4m).

EMPLOYEES

Employee involvement

The Group recognises the importance of its employees and is committed to effective two-way communication and consultation.

The Group has established Business Involvement Groups to facilitate meaningful consultation between Group Management and employees through elected Employee Representatives. The Groups meet regularly at both functional and company-wide levels.

The Group also recognises the rights of every employee to join a trade union and participate in its activities. SWS has a single union agreement with Unison.

The Group publishes its own in-house newspaper, 'Southern Water News' on a regular basis. General information is posted on the Group Intranet and regular team briefing sessions are also held.

Equal opportunity

The Group's policy is to promote equality of opportunity in recruitment, employment continuity, training and career development. The policy is designed to ensure that equal opportunity in these areas extends as far as practicable to people with disabilities.

Disabled employees

The Group gives full consideration to applications for employment from disabled persons where the requirements of the job can be adequately fulfilled by a disabled person. Where existing employees become disabled it is the Group's policy wherever practicable to provide continuing employment under normal terms and conditions. The Group's policy is to provide training and career development and promotion to disabled employees wherever appropriate.

Health and safety

The Group recognises its duties to make proper provision for the health, safety and welfare at work of its employees.

Every employee receives a copy of the corporate policy statement on health and safety. There are regular meetings of employee representatives and managers to consider all aspects of health and safety. In addition there is a health and safety management review group which ensures that there is an adequate system for meeting the Group's responsibilities for health and safety to its staff, customers and members of the public.

The Group provides an internal occupational health service for employees, including the provision of physiotherapy. These services have been developed and are continuously reviewed to ensure they meet the needs of the business and our employees at work.

CREDITOR PAYMENT POLICY AND PRACTICE

The Group's policy and practice is to agree terms of payment when agreeing the terms of the transaction, to include the terms in contracts and to pay in accordance with its contractual and legal obligations. The Group's trade creditor days at 31 March 2007 were 35 days (2006: 22 days).

SOUTHERN WATER CAPITAL LIMITED

REPORT OF THE DIRECTORS (continued)

ENVIRONMENTAL ISSUES

The Group is committed to meeting or improving upon legislative and regulatory environmental requirements and codes of practice, and aims to contain the environmental impact of its activities to a practicable minimum

The Group's environmental performance is reported in its annual Sustainability Report, which is available on our website. The Group recognises its responsibility to operate within a framework that supports sustainable development and has established, where possible, indicator targets which are measurable. Performance against these targets is monitored and reported regularly.

CHARITABLE DONATIONS

The Group made donations of £19,000 (2006 £21,000) to a variety of charities over the year.

No political donations were made.

LAND AND BUILDINGS

In the opinion of the directors, the market value of land is significantly more than its book value, and it would not be practicable to quantify the value of land.

FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES

The Group intends to at least maintain its present risk profile, as measured by its investment grade credit rating. The Group does not enter into treasury transactions for the purpose of speculation, but only to manage risk inherent in the business or funding on a prudent basis.

Currency Risk - The Group uses derivatives to ensure that no currency risk is borne in respect of any foreign currency denominated debt instrument, or in respect of any significant foreign currency purchases (including Financial Guarantee Fees, payable in respect of any foreign currency denominated Authorised Credit Facility and excluding any related fees).

Interest Rate Risk - The Group hedges its exposure to interest rate risk on at least 85% of its total outstanding debt liabilities in respect of Class A Debt and Class B Debt for the current period to the next Periodic Review and at least 70% in the next period to the subsequent Periodic Review (on a rolling basis) into either index-linked obligations or fixed rate obligations.

Inflation Risk - The regulatory framework, under which revenues and the RCV (Regulatory Capital Value) are indexed, exposes the Group to inflation risk. The Group manages this risk through the use of index-linked instruments within its overall debt portfolio.

Liquidity risk - The Group raises additional funds, as required, to ensure that it has sufficient cash and/or facilities to fund the business for at least the next twelve months.

Cash management risk - The Group sets exposure limits for, and deposits cash balances with, organisations whose credit ratings are rated a minimum of Moody's P1, Standard & Poors A1 or Fitch F1.

SOUTHERN WATER CAPITAL LIMITED

STATEMENT OF DIRECTORS' RESPONSIBILITIES

Company law requires the directors to prepare accounts for each financial period which give a true and fair view of the state of affairs of the Group as at the end of the financial period and of the profit or loss of the Group for that period

Having assessed the future funding requirements of the Group, the directors are of the opinion that it is appropriate for the accounts to be prepared on a going concern basis

The directors confirm that suitable accounting policies have been used and applied consistently and that reasonable and prudent judgements and estimates have been made in preparing the accounts for the year ended 31 March 2007. They also confirm that the financial statements have been prepared in accordance with United Kingdom Generally Accepted Accounting practice and that applicable accounting standards have been followed, subject to any material departures disclosed and explained

The directors are responsible for ensuring that the accounts are published, and where they are published on the internet, for the maintenance and integrity of the website. Uncertainty regarding legal requirements is compounded, as information published on the internet is accessible in many countries with different legal requirements relating to the preparation and dissemination of accounts

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and enable them to ensure that the accounts comply with the Companies Act 1985. More broadly, they owe a fiduciary duty to the Group and are responsible for safeguarding its assets

PROVISION OF INFORMATION TO AUDITORS

So far as the directors are aware, there is no relevant information of which the Group's auditors are unaware. The directors have taken all the steps, (such as making enquiries of other directors and the auditors and any other steps required by the director's duty to exercise due care, skill and diligence), that they ought to have taken in their duty as a director in order to make themselves aware of any relevant audit information and to establish that the Group's auditors are aware of that information

AUDITORS

The auditors, PricewaterhouseCoopers LLP, have indicated their willingness to continue in office

Approved by the Board of Directors and signed on behalf of the Board



D Workman
Director 26 September 2007.

SOUTHERN WATER CAPITAL LIMITED

CONSOLIDATED PROFIT AND LOSS ACCOUNT

for the year ended 31 March 2007

| | Notes | 31 March 2007 £m | 31 March 2007 £m | 31 March 2006 £m | 31 March 2006 £m |
|--|-------|------------------------|------------------------|------------------------|------------------------|
| Turnover | 1,2,3 | | 575.8 | | 541.5 |
| Cost of sales | 3 | | (311.4) | | (287.7) |
| Gross profit | | | 264.4 | | 253.8 |
| Administrative expenses | 3 | | | | |
| - before exceptional items | 4 | (29.3) | | (28.1) | |
| - exceptional items | 4 | (25.0) | | (8.4) | |
| Administrative expenses | | | (54.3) | | (36.5) |
| Other operating income | 3 | | 1.6 | | 2.5 |
| Operating profit and profit on ordinary activities before interest and taxation | 4 | | 211.7 | | 219.8 |
| Profit on disposal of fixed assets | | | 19.2 | | 8.6 |
| Net interest and similar charges | 7 | | (183.2) | | (173.2) |
| Profit on ordinary activities before taxation | | | 47.7 | | 55.2 |
| Tax on profit on ordinary activities | 8 | | (17.1) | | (20.4) |
| Profit on ordinary activities after taxation | | | 30.6 | | 34.8 |
| Equity Minority Interests | | | - | | (8.4) |
| Dividends | 9 | | - | | (10.0) |
| Retained profit for the financial year | 21 | | 30.6 | | 16.4 |

The above results relate to continuing operations

There was no difference between the profit on ordinary activities before taxation and the retained profit for the financial year stated above, and their historical cost equivalent

The Notes on pages 31 to 55 form part of these accounts

SOUTHERN WATER CAPITAL LIMITED

CONSOLIDATED STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

For the year ended 31 March 2007

| | Notes | 2007 £m | 2006 £m |
|---|-------|--------------------|---------------|
| Profit on ordinary activities after taxation | | 30.6 | 34.8 |
| Actuarial gain/(loss) recognised in the pension fund | 23 | 27.4 | (1.6) |
| Movement on deferred tax relating to pension deficit | | (8.2) | 0.5 |
| Minority interest | | - | (0.3) |
| Realisation of property revaluation gains | 21 | 0.5 | - |
| Total recognised gains for the year | | <u>50.3</u> | <u>33.4</u> |
| Prior year adjustment | 21 | 2.5 | (57.1) |
| Minority Interest | | - | (14.2) |
| Total gains/(losses) recognised since last annual report | | <u>52.8</u> | <u>(37.9)</u> |
| Attributable to: | | | |
| Equity shareholders | | 52.8 | (31.8) |
| Minority interests | | - | (6.1) |
| | | <u>52.8</u> | <u>(37.9)</u> |

There is no difference between the profit on ordinary activities before taxation and the retained loss for the year stated above and their historical cost equivalents

SOUTHERN WATER CAPITAL LIMITED

CONSOLIDATED BALANCE SHEET

as at 31 March 2007

| | Notes | Group 2007 £m | Company 2007 £m | Group 2006 £m | Company 2006 £m |
|---|-------|---------------------|-----------------------|---------------------|-----------------------|
| Fixed Assets | | | | | |
| Intangible assets – Goodwill | | - | - | - | - |
| Tangible assets | 10 | 3,583.1 | - | 3,144.1 | - |
| Investments | 11 | 7.0 | 321.2 | 7.0 | 37.5 |
| | | <u>3,590.1</u> | <u>321.2</u> | <u>3,151.1</u> | <u>37.5</u> |
| Current assets | | | | | |
| Stocks | 12 | 2.2 | - | 1.1 | - |
| Debtors amounts falling due within one year | 13 | 177.2 | 1.4 | 118.8 | 0.5 |
| Debtors amounts falling due after one year | 14 | - | 233.2 | - | - |
| Cash at bank and in hand | 18 | 273.3 | 36.4 | 247.3 | 3.4 |
| | | <u>452.7</u> | <u>271.0</u> | <u>367.2</u> | <u>3.9</u> |
| Creditors, amounts falling due within one year | 15 | <u>(343.1)</u> | <u>(5.7)</u> | <u>(217.4)</u> | <u>(0.2)</u> |
| Net current assets | | <u>109.6</u> | <u>265.3</u> | <u>149.8</u> | <u>3.7</u> |
| Total assets less current liabilities | | <u>3,699.7</u> | <u>586.5</u> | <u>3,300.9</u> | <u>41.2</u> |
| Creditors, amounts falling due after one year | 16 | <u>(3,072.9)</u> | <u>(530.4)</u> | <u>(2,796.9)</u> | <u>-</u> |
| Provision for liabilities and charges | 17 | <u>(382.6)</u> | <u>-</u> | <u>(342.7)</u> | <u>-</u> |
| Grants and contributions | 19 | <u>(47.9)</u> | <u>-</u> | <u>(46.2)</u> | <u>-</u> |
| Net assets excluding pension deficit | | <u>196.3</u> | <u>56.1</u> | <u>115.1</u> | <u>41.2</u> |
| Pension deficit | | <u>(72.8)</u> | <u>-</u> | <u>(96.6)</u> | <u>-</u> |
| Net assets including pension deficit | | <u>123.5</u> | <u>56.1</u> | <u>18.5</u> | <u>41.2</u> |
| Capital and reserves | | | | | |
| Called up share capital | 20 | 40.1 | 40.1 | 40.1 | 40.1 |
| Revaluation reserve | 21 | 58.6 | - | - | - |
| Profit and loss account | 21 | 24.8 | 16.0 | (28.0) | 1.1 |
| Total shareholder's funds (including non-equity interests) | | <u>123.5</u> | <u>56.1</u> | <u>12.1</u> | <u>41.2</u> |
| Equity minority interests | | <u>-</u> | <u>-</u> | <u>6.4</u> | <u>-</u> |
| Capital employed | | <u>123.5</u> | <u>56.1</u> | <u>18.5</u> | <u>41.2</u> |

The accounts on pages 27 to 55 were approved by the Board and authorised for issue on and are signed on its behalf by


 D Workman
 Director 26 September 2007

SOUTHERN WATER CAPITAL LIMITED

CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 March 2007

| | Notes | March 2007 £m | March 2006 £m |
|--|-------|---------------------|---------------------|
| Net cash inflow from operating activities | 22 | 343.7 | 335.6 |
| Returns on investments and servicing of finance | | | |
| Issue costs of new loans/redemption premium | | (3.4) | (8.6) |
| Interest paid | | (53.4) | (162.3) |
| Interest received | | 14.1 | 18.9 |
| Preference share dividends | | - | (13.7) |
| Dividends paid to minority interests | | - | (1.6) |
| Net cash outflow from returns on investments and servicing of finance | | <u>(42.7)</u> | <u>(167.3)</u> |
| Capital expenditure and financial investment | | | |
| Purchase of tangible fixed assets | | (505.3) | (272.5) |
| Sale of tangible fixed assets | | 9.3 | 9.8 |
| Receipt of grants and contributions | | 10.2 | 13.8 |
| Net cash outflow for capital expenditure and financial investment | | <u>(485.8)</u> | <u>(248.9)</u> |
| Investing activities | | | |
| Acquisition of minority interest in subsidiary undertaking | | (283.7) | - |
| Net cash outflow for investing activities | | <u>(283.7)</u> | <u>-</u> |
| Equity dividends paid to shareholders | | - | (10.0) |
| Net cash outflow before financing | | <u>(468.5)</u> | <u>(90.6)</u> |
| Financing | | | |
| Repayment of short term loan/bonds | | - | (420.0) |
| Issue of long term loans/bonds | | 497.5 | 499.5 |
| Net cash inflow from financing | | <u>497.5</u> | <u>79.5</u> |
| Increase/(decrease) in net cash | | <u>29.0</u> | <u>(11.1)</u> |
| Reconciliation to net debt | | | |
| Net debt at beginning of year | | (2,570.5) | (2,474.3) |
| Increase/(decrease) in net cash | | 29.0 | (11.1) |
| Movement in borrowings | | (237.5) | (79.5) |
| Debt issue costs/redemption premium | | 3.4 | 8.6 |
| Non-cash items | | (24.3) | (14.2) |
| Net debt at end of year | 22 | <u>(2,799.9)</u> | <u>(2,570.5)</u> |

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

1 Accounting policies

Basis of accounting

The accounts have been prepared under the historical cost convention as modified by the revaluation of freehold land and buildings and infrastructure assets and in accordance with applicable accounting standards and, subject to the treatment of infrastructure grants and contributions described below, with the requirements of the Companies Act 1985

Basis of consolidation

The Group accounts include the accounts of the Company and all of its subsidiary undertakings. The results of the subsidiaries are included in the Profit and Loss Account from the date of acquisition. Intra group sales and profits are eliminated fully on consolidation. The acquisition method of accounting has been used to consolidate the subsidiaries.

No profit and loss account is presented by the Company as permitted by Section 230 of the Companies Act 1985.

The Company is not required to prepare a cash flow statement under FRS 1 (revised).

Turnover

Turnover represents the income receivable (excluding value added tax) in the ordinary course of the business for goods and services provided and, in respect of unbilled charges, includes an accrual for measured and unmeasured income.

Measured income arises from customers who have meters fitted at their premises. Therefore amounts billed are based on actual water consumption. Unmeasured income bills are based on the rateable value of properties. The income accrual is an estimation of the amount of mains water and wastewater charges unbilled at the year end. The accrual is estimated using a defined methodology based upon weighted average tariffs and historical billing and consumption information.

Bad debts

The bad debt provision is calculated by applying recovery rates to an aged debt profile to ensure that the age of debt not covered by the provision is an accurate reflection of the recoverability of debt.

Research and development

Expenditure on research and development is charged to the profit and loss account as it is incurred.

Capital instruments

The issue costs of capital instruments have been amortised over the life of the financial instrument to which they relate.

Premiums received on issue of debt instruments are credited to the profit and loss account over the term of the debt at a constant rate on the carrying amount.

The carrying value of index-linked debt instruments is adjusted for the annual movement in the retail price index. The change in value arising from indexation is charged or credited to the profit and loss account in the year in which it arises.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

1 Accounting policies (continued)

Tangible fixed assets

- i) Infrastructure assets (being mains and sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls) comprise a network of systems

Expenditure on infrastructure assets relating to increases in capacity or enhancement of the network and on maintaining the operating capability of the network in accordance with defined standards of service, is treated as an addition to fixed assets and is stated at cost after deducting grants and contributions. Staff costs represent those costs directly related to the construction of a specific infrastructure asset and are capitalised as part of infrastructure assets on the basis of the amount of time spent by individuals on capital projects.

The depreciation charge for infrastructure assets is the estimated level of annualised expenditure required to maintain the operating capability of the network and is based on the asset management plan determined by the water industry regulator as part of the price regulation process. The asset management plan is developed from historical experience combined with a rolling programme of reviews of the condition of the infrastructure assets.

- ii) Other assets (including over-ground assets, plant and equipment) are stated at cost less accumulated depreciation. Other assets are depreciated on the straight-line method over their estimated operating lives which are principally as follows:

| | <u>Years</u> |
|--------------------------------------|--------------|
| Buildings | 10 - 60 |
| Operational structures | 15 - 80 |
| Fixed plant | 10 - 40 |
| Vehicles, computers and mobile plant | 3 - 10 |

Operational structures are assets used for wastewater and water treatment purposes. These include water tanks and similar assets.

- iii) Freehold land is not depreciated.

Assets in the course of construction are not depreciated until they are commissioned. Commissioning is deemed to occur when a new work is officially taken over from the contractor following completion of performance and take-over tests.

- iv) Increases in the carrying amount arising on revaluation are credited to revaluation and other reserves in shareholders' equity.

Grants and contributions

Capital grants and customer contributions in respect of additions to non-infrastructure fixed assets are treated as deferred income and released to the profit and loss account over the estimated operational lives of the related assets in accordance with the provisions of the Companies Act.

Grants and capital contributions received relating to infrastructure assets have been deducted from the cost of fixed assets. This is not in accordance with Schedule 4 of the Companies Act 1985 which requires fixed assets to be stated at their purchase price or production cost. The Act does not permit the deduction of contributions, hence these would have been accounted for as deferred income.

This departure from the requirements of the Act is, in the opinion of the directors, necessary for the accounts to give a true and fair view because infrastructure assets do not have determinable finite lives. Accordingly related capital contributions would not be recognised in the profit and loss account. The effect of this treatment on tangible fixed assets is disclosed in note 10.

Revenue grants and contributions are credited to the profit and loss account in the year to which they relate.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

1 Accounting policies (continued)

Leased assets

Fixed assets leased to the Group under finance leases are capitalised and depreciated in line with the Group's depreciation policy. The interest element of finance lease repayments is charged to the profit and loss account in proportion to the balance of the capital repayments outstanding.

Rentals payable under operating leases are charged to profit and loss account as incurred.

In line with SSAP 21, the sale of income rights relating to aerials, masts and sites owned by the company to third parties is treated as an operating lease. Income received from such sales is received entirely in advance and is therefore taken to deferred revenue and will be credited to the profit and loss account over the life of the lease.

Sale and leaseback transactions occur when an asset is sold but use is immediately re-acquired by entering into a lease with the buyer. Where the new lease is an operating lease, the transaction is treated as the disposal of an asset and the operating lease accounted for in accordance with existing policies.

Goodwill and intangible fixed assets

Businesses and interests acquired have been dealt with in the consolidated accounts using acquisition accounting. Upon the acquisition of a business, fair values are attributed to the identifiable assets and liabilities acquired that reflect the condition at the date of acquisition and any required adjustments made to bring the accounting policies of the businesses acquired into alignment with those of the Group. Where the consideration paid exceeds the fair value of the net assets acquired, the difference is treated as goodwill.

In line with FRS 10, goodwill arising on acquisitions is capitalised and amortised through the profit and loss account over its estimated useful economic life, not exceeding 20 years.

Impairment reviews of goodwill are carried out at the end of the first financial year after acquisition and where there is any indication of impairment.

Fixed asset investments

Investments held as fixed assets are stated at cost, less provision, if appropriate, for any impairment in value other than a temporary impairment in value. The carrying values of fixed asset investments are reviewed for impairment in periods if events or changes in circumstances indicate the carrying value may not be recoverable.

Stocks

Stocks are valued at the lower of cost and net realisable value.

Taxation

The taxation charge in the profit and loss account is based on the profit for the year as adjusted for disallowable and non-taxable items using current rates and takes into account tax deferred because of timing differences between the treatment of certain items for taxation and accounting purposes. Deferred taxation is provided on all timing differences that have originated but not reversed by the balance sheet date, calculated at the rate at which it is expected the tax will arise in accordance with Financial Reporting Standard 19 "Deferred Tax" ("FRS 19"). Deferred taxation balances are not discounted. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

1 Accounting policies (continued)

Pensions

The Group operates a defined benefit pension scheme. An independent actuary conducts a valuation of this pension scheme every three years.

In accordance with FRS 17 the pension deficit has been recognised on the balance sheet and operating and financing costs of pension and post-retirement schemes are recognised separately in the profit and loss account. Service costs are systematically spread over the service lives of the employees and financing costs are recognised in the period in which they arise. The costs of past service benefit enhancements, settlements and curtailments are also recognised in the period in which they arise.

The differences between actual and expected returns on assets and liabilities during the year, including changes in actuarial assumptions, are recognised in the statement of total recognised gains and losses.

Financial instruments

Derivative transactions include interest rate, currency and index-linked swaps that are only used for non trading purposes. These derivatives are entered into for the purpose of matching or eliminating risk from potential movements in interest and currency rates and RPI associated with the long term borrowing requirements of the Group (see note 18). All non trading derivatives are accounted for on an accruals basis.

Provisions are made for losses, if appropriate, in the event that it is expected that any portion of a financial instrument will not be a hedge of the long term borrowing requirements of the Group.

Interest rate and currency swaps are used to manage interest rate profiles and mitigate exchange risks. When matched with primary financial instruments, the net position is measured at the hedge rate and presented within creditors on the balance sheet. Income, costs, gains, losses and expenses are recognised within net interest payable in the profit and loss account over the life of the instruments.

Provisions

An environmental provision is made in accordance with FRS12 for the costs relating to the decommissioning of abandoned sites. No reimbursement is expected. The period over which the provision will be utilised cannot be determined thus the provision is not discounted.

2 Segmental analysis

The directors believe that the whole of the Group's activities constitute a single class of business. The Group's turnover is generated wholly from within the UK.

3 Classification of turnover and revenue costs

Turnover represents the income receivable for providing water supply and wastewater services and is generated wholly in the United Kingdom.

Cost of sales reflects the direct costs of providing water supply and wastewater services. Administrative expenses comprise the indirect costs of the business. Other operating income relates to rents receivable.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

4 Profit on ordinary activities before taxation

| | March 2007 £m | March 2006 £m |
|--|---------------------|---------------------|
| Profit on ordinary activities before taxation is stated after charging/(crediting) | | |
| Staff costs (note 6a) | 48.5 | 47.6 |
| Depreciation on | | |
| - owned assets | 144.2 | 141.6 |
| - assets held under finance leases | 0.4 | 0.4 |
| | 144.6 | 142.0 |
| Rentals under operating leases – other | 3.8 | 3.7 |
| Research and development expenditure | 1.3 | 1.4 |
| Release of grants and contributions (note 19) | (2.4) | (2.2) |
| Exceptional item (see note 17) | 25.0 | 8.4 |

During the year, the company's auditors earned the following fees

| | | |
|---|-----|-----|
| Fees payable for the audit of parent company and consolidated annual accounts | 0.1 | - |
| Fees payable for the audit of the company's subsidiaries' and associated pension scheme annual accounts | 0.2 | 0.2 |
| Fees payable for other services pursuant to legislation | 0.1 | 0.1 |
| Fees payable for services relating to corporate finance transactions | 0.1 | - |
| Fees payable for all other services to the group | 0.5 | 1.7 |
| Total audit and non-audit fees | 1.0 | 2.0 |

Fees in respect of other services relate to non-financial data reporting

5 Profit of Parent Company

The company has not presented its own profit and loss account as permitted by section 230 of the Companies Act 1985. The profit for the financial year dealt with in the financial statements of the parent company is £14.9m (March 2006 Loss £3.0m)

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

6 Employee information

| | March 2007 £m | March 2006 £m |
|---|----------------------|----------------------|
| (a) Employee costs (including directors' emoluments – see note 26) | | |
| Wages and salaries | 51.7 | 49.1 |
| Social security costs | 4.2 | 3.9 |
| Pension costs | 6.1 | 7.6 |
| | 62.0 | 60.6 |
| Total employee costs | 62.0 | 60.6 |
| Less charged as capital expenditure | (13.5) | (13.0) |
| Charged to the profit and loss account | 48.5 | 47.6 |
| | | |
| | March 2007 No. | March 2006 No. |
| (b) Average number of persons employed | | |
| Operations | 1,157 | 1,234 |
| Customer Services | 289 | 279 |
| Corporate Centre | 452 | 388 |
| | 1,898 | 1,901 |

7 Net interest and similar charges

| | March 2007 £m | March 2006 £m |
|---------------------------------|---------------------|---------------------|
| Interest payable | | |
| Interest payable on other loans | 178.3 | 159.5 |
| Interest rate swap payments | - | 2.0 |
| Indexation | 32.0 | 19.8 |
| Other finance expense (note 23) | - | 2.6 |
| Amortisation of issue costs | 2.5 | 4.4 |
| Amortisation of bond premium | (10.0) | (9.9) |
| Interest on preference shares | - | 13.7 |
| Total interest payable | 202.8 | 192.1 |
| Interest receivable | | |
| Other interest receivable | 19.6 | 18.9 |
| Net interest charge | 183.2 | 173.2 |

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

8 Tax on profit on ordinary activities

| | Year to 31 March 2007 £m | Period to 31 March 2006 £m |
|--|--------------------------------------|--|
| Current tax | | |
| UK corporation tax on profits of the period | - | - |
| Adjustment in respect of prior years | - | - |
| | - | - |
| Deferred tax | | |
| Origination and reversal of timing differences | 19.2 | 19.2 |
| Pension cost relief in excess of pension cost charge | 2.1 | 1.2 |
| Prior year adjustment | (4.2) | - |
| Total deferred tax | 17.1 | 20.4 |
| Total tax on profit on ordinary activities | 17.1 | 20.4 |

The rate of current tax charge on profit on ordinary activities varied from the standard rate of corporation tax due to the following factors

| | 2007 £m | 2006 £m |
|---|-------------|-------------|
| Current tax | | |
| UK corporation tax rate at 30% on profit for the period | 14.3 | 16.5 |
| Adjustment in respect of prior years | - | - |
| Other differences | - | 0.7 |
| Provision for OFWAT fine | 7.5 | - |
| Sale of capital assets with no charge arising | (6.1) | - |
| Permanent differences | 5.9 | 3.2 |
| Losses utilised not previously recognised | (0.3) | - |
| Tax charge on ordinary activities | 21.3 | 20.4 |
| Effect of deferred tax | (21.3) | (20.4) |
| Current tax charge for period | - | - |

9 Dividends per share

| | 2007 £ per ordinary share | 2006 £ per ordinary share | 2007 £m | 2006 £m |
|--------------------------------|------------------------------------|------------------------------------|------------|-------------|
| Ordinary shares | | | | |
| Interim dividend | - | 0.25 | - | 10.0 |
| Total ordinary dividend | - | 0.25 | - | 10.0 |

A final dividend of £5.60 per ordinary share (£28.0m in total) was declared in April 2007 and paid in May 2007

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

10 Fixed assets and capital commitments

The Group tangible assets are shown below. The Company has no tangible assets.

(a) Group tangible assets

| | Freehold land & buildings £m | Plant & Machinery £m | Infra- structure assets £m | Assets in the course of const- ruction £m | Other £m | Total £m |
|-------------------------|---------------------------------------|----------------------------|-------------------------------------|---|--------------|----------------|
| Cost: | | | | | | |
| At 1 April 2006 | 908.3 | 865.3 | 1,229.3 | 321.2 | 158.8 | 3,482.9 |
| Additions | 15.9 | 21.9 | 15.0 | 469.9 | 2.7 | 525.4 |
| Revaluation in year | 33.5 | - | 45.3 | - | - | 78.8 |
| Transfers | 60.4 | 93.4 | 51.5 | (227.3) | 22.0 | - |
| Grants & contributions | - | - | (6.1) | - | - | (6.1) |
| Disposals | (23.4) | (3.6) | (1.8) | - | (3.5) | (32.3) |
| At 31 March 2007 | 994.7 | 977.0 | 1,333.2 | 563.8 | 180.0 | 4,048.7 |
| Depreciation: | | | | | | |
| At 1 April 2006 | 83.9 | 121.4 | 89.3 | - | 44.2 | 338.8 |
| Charge for the period | 30.8 | 42.9 | 41.5 | - | 28.2 | 143.4 |
| On revaluations | 1.2 | - | - | - | - | 1.2 |
| Disposals | (9.0) | (3.6) | (1.8) | - | (3.4) | (17.8) |
| At 31 March 2007 | 106.9 | 160.7 | 129.0 | - | 69.0 | 465.6 |
| Net book value: | | | | | | |
| At 31 March 2007 | 887.8 | 816.3 | 1,204.2 | 563.8 | 111.0 | 3,583.1 |
| At 31 March 2006 | 824.4 | 743.9 | 1,140.0 | 321.2 | 114.6 | 3,144.1 |

Of the additions to infrastructure assets, the amount spent on infrastructure renewals during the year ended 31 March 2007 was £63.9m (2006 £45.9m). Of the grants and contributions set against infrastructure assets during the year ended 31 March 2007, £2.7m (2006 £5.1m) relates to infrastructure renewals.

For the year ended 31 March 2007, the net book value of infrastructure assets is stated after deducting grants and contributions of £154.2m (2006 £148.1m).

Freehold land is stated at a cost of £65.9m (2006 £64.8m restated) at 31 March 2007, and is not depreciated.

Other assets relate primarily to computer equipment and meter reading devices.

Assets held under finance leases are capitalised and included in plant and machinery.

| | | |
|--------------------------------------|------------------------------|---------------------|
| | Group 2007 £m | Group 2006 £m |
| Cost | 11.7 | 11.7 |
| Aggregate depreciation | (8.6) | (8.2) |
| Net book amount | <u>3.1</u> | <u>3.5</u> |
| (b) Group Capital Commitments | 2007 £m | 2006 £m |
| In respect of contracts placed | <u>417.1</u> | <u>741.0</u> |

The company has no capital commitments.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

11 Fixed asset investments

| | Group 2007 £m | Company 2007 £m | Group 2006 £m | Company 2006 £m |
|--|---------------------|-----------------------|---------------------|-----------------------|
| Southern Water Investments Limited | | | | |
| At 1 April | - | 37.5 | - | 40.1 |
| Acquisition in year | - | 283.7 | - | - |
| Disposal in year | - | - | - | (2.6) |
| At 31 March | - | 321.2 | - | 37.5 |
| Other external investments (see below) | 7.0 | - | 7.0 | - |
| | <u>7.0</u> | <u>321.2</u> | <u>7.0</u> | <u>37.5</u> |

Other Group external investments are stated below

| Company | Class of share capital | Proportion of shares held | Activity |
|---------------------------------------|------------------------------------|---------------------------|----------------------------|
| Folkestone & Dover Water Services Ltd | Ordinary Preference Deferred | 25.1% 21.8% 12.2% | Water treatment and supply |

The undertaking operates in its country of incorporation (the UK). The investment is held by a subsidiary of Southern Water Capital Limited. Folkestone & Dover Water Services Ltd had retained profits of £0.5m for the year ended 31 March 2007 (2006 Loss £0.5m) and net assets of £18.3m at 31 March 2007 (2006 £18.5m).

As at 1 April 2006, the Company owned 7,500,000 Ordinary Shares of £1 (75% of the issued share capital) of Southern Water Investments Limited ("SWIL"), the remaining 25% being held by Veolia Water Investments Limited ("VWIL"). The Company acquired VWIL's entire shareholding on the 10 April 2006. This acquisition of the minority interest has been accounted for in the consolidated accounts using the acquisition accounting method.

The net assets of SWIL acquired by Southern Water Capital Limited on 10 April 2006 have been adjusted during the year to 31 March 2007 as follows:

| | Book value £m | Adjustments £m | Fair value £m |
|--|------------------|-------------------|------------------|
| Fixed assets | 3,151.1 | 78.8 | 3,229.9 |
| Stock | 1.1 | - | 1.1 |
| Debtors | 119.9 | - | 119.9 |
| Cash | 243.9 | - | 243.9 |
| Creditors | (3,014.6) | - | (3,014.6) |
| Provisions | (342.7) | - | (342.7) |
| Grants and contributions | (46.2) | - | (46.2) |
| Pension deficit | (96.6) | - | (96.6) |
| Net assets acquired | <u>15.9</u> | <u>78.8</u> | <u>94.7</u> |
| 25% of assets acquired | | | 23.7 |
| Preference shares acquired | | | 260.0 |
| Goodwill | | | - |
| | | | <u>283.7</u> |
| Settled by: | | | |
| Cash payment | | | 283.7 |
| Total fair value of consideration | | | <u>283.7</u> |

SWIL itself owns the entire issued capital of Southern Water Services Group Limited and Southern Water NR Holdings Limited. A full list of the company subsidiaries is shown in note 28.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

12 Stocks

| | Group 2007 £m | Group 2006 £m |
|------------------|---------------------|---------------------|
| Raw materials | 0.9 | 0.8 |
| Work in progress | 1.3 | 0.3 |
| | 2.2 | 1.1 |

The Company does not hold any stock

13 Debtors: amounts falling due within one year

| | Group 2007 £m | Company 2007 £m | Group 2006 £m | Company 2006 £m |
|--|---------------------|-----------------------|---------------------|-----------------------|
| Trade debtors | 87.5 | - | 62.3 | - |
| Unbilled income | 53.2 | - | 40.6 | - |
| Prepayments | 3.7 | - | 2.9 | - |
| Other debtors | 32.8 | 0.9 | 13.0 | - |
| Amounts owed by other Southern Water group undertakings | - | 0.5 | - | 0.5 |
| | 177.2 | 1.4 | 118.8 | 0.5 |

14 Debtors: amounts falling due after one year

| | Group 2007 £m | Company 2007 £m | Group 2006 £m | Company 2006 £m |
|--|---------------------|-----------------------|---------------------|-----------------------|
| Amounts owed by other Southern Water group undertakings | - | 233.2 | - | - |
| | - | 233.2 | - | - |

15 Creditors: amounts falling due within one year

| | Group 2007 £m | Company 2007 £m | Group 2006 £m | Company 2006 £m |
|--|---------------------|-----------------------|---------------------|-----------------------|
| Bank overdraft | 10.3 | - | 13.3 | - |
| Trade creditors | 17.0 | - | 16.0 | - |
| Capital creditors and capital accruals | 134.2 | - | 114.0 | - |
| Other taxation and social security | 1.4 | - | 1.4 | - |
| Other accruals and deferred revenue | 172.7 | 5.7 | 65.2 | 0.2 |
| Bond premium deferred | 10.0 | - | 9.9 | - |
| Debt issue costs | (2.5) | - | (2.4) | - |
| | 343.1 | 5.7 | 217.4 | 0.2 |

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

16 Creditors' amounts falling due after one year

| | Group 2007 £m | Company 2007 £m | Group 2006 £m | Company 2006 £m |
|--|---------------------|-----------------------|---------------------|-----------------------|
| Loans and other borrowings | | | | |
| Long term borrowings | 2,916.1 | 532.2 | 2,646.7 | - |
| Debt issue costs | (52.9) | (1.8) | (52.0) | - |
| Bond premium deferred | 192.2 | - | 202.2 | - |
| Total loans and other borrowings | <u>3,055.4</u> | <u>530.4</u> | <u>2,796.9</u> | <u>-</u> |
| Deferred revenue (note (v) below) | 17.5 | - | - | - |
| Total creditors falling due after one year | <u>3,072.9</u> | <u>530.4</u> | <u>2,796.9</u> | <u>-</u> |
| | | | 2007 £m | 2006 £m |
| Repayments fall due as follows: | | | | |
| Between two and five years | | | - | - |
| After five years not by instalments | | | <u>2,916.1</u> | <u>2,796.9</u> |
| | | | <u>2,916.1</u> | <u>2,796.9</u> |

An analysis of the external loans is shown below -

| Loans | Group 2007 £m | Group 2006 £m |
|--|---------------------|---------------------|
| Class A £350m 6.192% fixed rate 2029 | 350.0 | 350.0 |
| Class A £150m 3.706% index linked 2034 | 167.1 | 161.8 |
| Class A £35m 3.706% index linked 2034 | 38.9 | 37.7 |
| Class A £350m 6.640% fixed rate 2026 | 350.0 | 350.0 |
| Class A £150m 3.816% index linked 2023 | 167.1 | 161.8 |
| Class A £350m 5.010% fixed rate 2021 | 349.9 | 349.9 |
| Class A £150m 2.295% index linked 2041 (note (i) below) | 153.2 | 149.6 |
| Class A £200m 4.500% fixed rate 2052 (note (i) below) | 203.8 | - |
| Class B £250m 7.869% fixed rate 2038 (note (ii) below) | 250.0 | 250.0 |
| Artesian £165m 4.076% index linked 2033 | 183.8 | 178.0 |
| Artesian £156.5m 3.635% index linked 2032 | 170.1 | 164.7 |
| Senior mezzanine £127.2m 11.96% fixed rate 2038 (note (iii) below) | 127.2 | 127.2 |
| Junior mezzanine £106m 16.0% fixed rate 2038 | 106.0 | 106.0 |
| Debt issue costs (note (iv) below) | (52.9) | (52.0) |
| Premium on issue | 192.2 | 202.2 |
| Term loan facility £175m variable | 175.0 | - |
| Unsecured loan notes £124m 9% fixed rate 2016 | 124.0 | - |
| Class A1 Preference shares | - | 150.0 |
| Class B Preference shares | - | 110.0 |
| Class A2 Preference shares | - | - |
| | <u>3,055.4</u> | <u>2,796.9</u> |

In April 2006, Southern Water Capital Limited raised debt finance totalling £299m in the form of £124m unsecured loan notes and £175m term loan facility to fund the acquisition of a minority interest stake of 25%, previously held by Veolia Water Investments Limited, in Southern Water Investments Limited.

In October 2007, Southern Water Services (Finance) Limited ("SWSF") raised further additional debt to the value of £200m. This debt has been on-lent to Southern Water Services Limited ("SWS") to fund the capital expenditure programme.

These loans are guaranteed and secured pursuant to a guarantee and security agreement (the Security Agreement). The agreement is over the entire property, assets, rights and undertaking of each of SWS, SWSF, SWS Holdings Limited, and SWS Group Holdings Limited. In the case of Southern Water Services Limited, this is to the extent permitted by the Water Industry Act 1991 and Licence.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

16 Creditors' amounts falling due after one year (continued)

Notes

- (i) The company has entered into swap agreements that have converted its Class A £150m and £200m bonds from fixed rates of 5.0% and 4.500% respectively, to index linked bonds with interest rates of 2.295% plus RPI and 1.740% plus RPI respectively
- (ii) The interest rate on the class B £250m is fixed at 7.869% until March 2014 when it steps up to LIBOR plus 4.75%
- (iii) The interest rate on the senior mezzanine £125m loan is fixed at 11.96% until March 2022 when it reverts to LIBOR plus 6.25%. For the remaining senior mezzanine loan of £2.2m the interest rate is LIBOR plus 6.25%
- (iv) Debt issue costs represent issue fees paid to SWSF. Where these costs are attributable to a specific instrument they are being amortised over the life of that instrument. The remaining costs are being amortised over the weighted average life of the loan advances noted above. As at 31 March 2007 debt issue costs amounted to £55.4m of which £2.5m represents the short-term amount which is disclosed separately in note 15.
- (v) Deferred revenue relates to the proceeds from the sale of income rights relating to aerial masts and sites owned by SWS. The income will be credited to the profit and loss account evenly over the life of the lease.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

17 Provision for liabilities and charges

| | Group 2007 £m | Group 2006 £m |
|--|---------------------|---------------------|
| (a) Environmental obligations | | |
| Provision brought forward | 2.1 | 2.3 |
| Written back in year | - | - |
| Utilised in year | <u>(0.1)</u> | <u>(0.2)</u> |
| Provision at 31 March 2007 | <u>2.0</u> | <u>2.1</u> |
| (b) Deferred taxation | | |
| Accelerated capital allowances | 424.9 | 420.2 |
| Other timing differences | <u>(69.3)</u> | <u>(79.6)</u> |
| Deferred taxation | <u>355.6</u> | <u>340.6</u> |
| (c) Provision for costs of customers services investigation | | |
| Provision brought forward | - | 5.7 |
| Provision made in year | - | - |
| Written back in year | <u>-</u> | <u>(5.7)</u> |
| Provision at 31 March 2007 | <u>-</u> | <u>-</u> |
| (d) Provision for OFWAT fine | | |
| Provision brought forward | - | - |
| Provision made in year | <u>25.0</u> | <u>-</u> |
| Provision at 31 March 2007 | <u>25.0</u> | <u>-</u> |
| Total | <u>382.6</u> | <u>342.7</u> |

The environmental provision relates to costs for the decommissioning of abandoned sites. No reimbursement is expected. As the period over which the provision will be utilised cannot be determined the provision is not discounted.

The provision for OFWAT fine represents management's best estimate based on the information available at the date of signing the accounts. The fine relates to the historical failure to meet customer service standards and the misreporting of customer services data.

| | Group 2007 £m | Group 2006 £m |
|--|---------------------|---------------------|
| Movement in deferred tax provision | | |
| Deferred tax provision brought forward | 340.6 | 321.4 |
| Prior year adjustment | (4.2) | - |
| Deferred tax charge in Profit and Loss Account | 19.2 | 19.2 |
| Deferred tax provided at 31 March | <u>355.6</u> | <u>340.6</u> |

The prior year adjustment relates to a reduction in deferred tax required as a result of additional deferred bond premiums in prior years.

No provision has been made for potential deferred tax liability on fair value adjustments made to the fixed assets recognised on acquisition. Such tax would only become payable if a contract was entered into to sell the related assets.

The total amount unprovided is £96.6m. At present it is not envisaged that any such tax will become payable in the foreseeable future.

The Company has no provisions for liabilities and charges.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

18 Financial instruments

Derivative activity is undertaken by a subsidiary in the Group, SWSF as determined by the Board, which considers the overall risk profile of the Group and enters into derivatives to mitigate or hedge any risks identified, as appropriate. No derivatives are undertaken for trading purposes, or to benefit from price fluctuations.

The SWSF business consists of lending to other group Companies and raising external finance. In the opinion of the Directors, the fair values of the financial assets and liabilities of the Group (apart from the specific financing loans and hedging instruments shown in the fair value table below) are not materially different from the book values and are not separately disclosed.

All fair values are based on arms length transactions in normal market conditions. Where available, market values have been used to determine fair values.

The fair value of the Group's long term borrowings has been estimated based on quoted market prices for the same or similar debt where possible. Where prices did not exist, the fair value has been estimated based on the calculations of the present value of future cash flows using the appropriate discount rates in effect at the balance sheet dates.

For foreign currency and interest rate swap agreements the fair value has been estimated based on market valuations at the balance sheet dates.

The Group has no material un-hedged monetary assets and liabilities denominated in a currency different from the local currency of the particular operation.

The table below describes the main activities and risks which lead to the use of derivatives.

| Activity | Risk | Type of hedge in place |
|-------------------------------------|---|--|
| Floating rate borrowing / financing | Increased interest expense due to increases in interest rates | Interest rate swaps which fix the amount of interest payable |
| Currency rate borrowing / financing | Increased currency losses due to increases in exchange rates | Currency rate swaps which fix the exchange rates |
| Indexation | The regulatory framework, under which revenues and the RCV are indexed, exposes the Group to inflation risk | Index-linked instruments |

On 23 July 2003, the Group carried out a refinancing transaction and entered in to a series of derivative transactions for the purpose of hedging risk associated with the long term borrowing requirements of the Southern Water Capital Group.

For the purposes of the notes below, short term debtors and creditors have been excluded.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

18 Financial instruments (continued)

Interest Rate Risk profile of financial liabilities

| Currency | Total | Index Linked financial liabilities | Fixed rate financial liabilities | Variable rate financial liabilities | Non equity fixed rate preference shares |
|-------------------------|-----------------------|--|--|--|--|
| | £m | £m | £m | £m | £m |
| GBP | 2,646.7 | 853.6 | 1,530.9 | 2.2 | 260.0 |
| At 31 March 2006 | <u>2,646.7</u> | <u>853.6</u> | <u>1,530.9</u> | <u>2.2</u> | <u>260.0</u> |
| GBP | 2,916.1 | 880.2 | 1,858.7 | 177.2 | - |
| At 31 March 2007 | <u>2,916.1</u> | <u>880.2</u> | <u>1,858.7</u> | <u>177.2</u> | <u>-</u> |

The balance above includes the debt raised in external finance markets (described further in note 16)

Fixed rate financial liabilities

| Currency | Weighted average interest rate % | Weighted average time for which rate is fixed Years |
|----------------------|--|--|
| GBP | | |
| 31 March 2006 | <u>7.5</u> | <u>18.1</u> |
| GBP | | |
| 31 March 2007 | <u>7.1</u> | <u>19.6</u> |

The Group held the following financial assets, as part of the financing arrangements at 31 March 2007

| | 31 March 2007 | 31 March 2006 |
|---------------------|---------------------|---------------------|
| | £m | £m |
| GBP Cash | 169.8 | 246.1 |
| GBP Restricted cash | 103.5 | 1.2 |
| | <u>273.3</u> | <u>247.3</u> |

Restricted cash of £103.5m is held in a designated bank account in order to meet the interest requirements on the loan finance. Interest of £98.2m was paid on the 2nd April 07

The above financial assets attract interest at floating rates

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

18 Financial instruments (continued)

Fair values of financial assets and financial liabilities

The following table provides a comparison by category of the carrying amounts and the fair values of the Group's financial assets and financial liabilities at 31 March 2007. Fair value is the amount at which a financial instrument could be exchanged in an arm's length transaction between informed and willing parties. Where available, market values have been used to determine fair values.

| | Book value 2007 £m | Fair value 2007 £m | Book value 2006 £m | Fair value 2006 £m |
|--|--------------------------|--------------------------|--------------------------|--------------------------|
| Long term borrowings | 2,916.1 | 3,198.1 | 2,646.7 | 3,072.0 |
| Restricted Cash | 103.5 | 103.5 | 1.2 | 1.2 |
| Cash at Bank and in Hand | 169.8 | 169.8 | 246.1 | 246.1 |
| Overdraft (note 15) | (10.3) | (10.3) | (13.3) | (13.3) |
| Derivative financial instruments held to manage interest rate profile | | | | |
| Interest Rate Swaps | - | (82.6) | - | (55.1) |

Hedges

The table below shows the extent to which the Group has off-balance sheet (unrecognised) and on-balance sheet (deferred) gains and losses in respect of financial instruments used as hedges at the beginning and end of the year. It also shows the amount of such gains and losses which have been included in the profit and loss account for the year and those gains and losses which are expected to be included in next year's or later profit and loss accounts.

All the gains and losses on the hedging instruments are expected to be matched by losses and gains on the hedged transactions or positions.

| | Unrecognised Losses £m |
|--|------------------------------|
| Losses on hedges at 1 April 2006 | (47.0) |
| Disposals in current year | - |
| Losses not realised 2007 | (35.6) |
| Losses on hedges at 31 March 2007 | (82.6) |
| Of which | |
| Gains and losses expected to be recognised within 2008 income | - |
| Gains and losses expected to be recognised within 2009 income or later | (82.6) |

In 2003 derivatives were put into place to hedge the anticipated bond issue. The bonds were issued at the hedged rate on the 23 July 2003. The premium proceeds on the bond issue were used to finance the payment of the swap break costs on the same date.

The losses of £35.6m for the current period relate to instruments which will continue to hedge the Group's exposure to movements in interest rates.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

19 Grants and contributions

| | Group £m |
|-------------------------------------|---------------------|
| At 1 April 2006 | 46.2 |
| Receivable in year | 4.1 |
| Released to profit and loss account | (2.4) |
| At 31 March 2007 | 47.9 |

Grants and Contributions relate to non-infrastructure assets

20 Share capital

| | Group and Company 2007 £m | Group and Company 2006 £m |
|--|--|--|
| Authorised | | |
| 5,000,000 ordinary A shares of £1 each | 5.0 | 5.0 |
| 195,000,000 ordinary B shares of £1 each | 195.0 | 195.0 |
| | 200.0 | 200.0 |
| Allotted, called up and fully paid | | |
| 5,000,000 ordinary A shares of £1 each | 5.0 | 5.0 |
| 35,050,000 ordinary B shares of £1 each | 35.1 | 35.1 |
| | 40.1 | 40.1 |

21 Reconciliation of movement in shareholder's funds

| Group | Called up share capital £m | Profit and loss account £m | Revaluation Reserve £m | Total £m |
|--|-------------------------------------|-------------------------------------|------------------------------|--------------|
| At 1 April 2005 | 40.1 | (43.3) | - | (3.2) |
| Profit for the year | - | 16.4 | - | 16.4 |
| Actuarial loss on pension scheme | - | (1.6) | - | (1.6) |
| Movement on deferred tax relating to pension asset | - | 0.5 | - | 0.5 |
| At 31 March 2006 | 40.1 | (28.0) | - | 12.1 |
| At 1 April 2006 | 40.1 | (28.0) | - | 12.1 |
| Prior year adjustment | - | 2.5 | - | 2.5 |
| Profit for the year | - | 30.6 | - | 30.6 |
| Revaluation in year | - | - | 59.1 | 59.1 |
| Realisation of property revaluation gains | - | 0.5 | (0.5) | - |
| Actuarial gain on pension scheme | - | 27.4 | - | 27.4 |
| Movement on deferred tax relating to pension asset | - | (8.2) | - | (8.2) |
| At 31 March 2007 | 40.1 | 24.8 | 58.6 | 123.5 |
| Company | Called up share capital £m | Profit and loss account £m | | |
| At 1 April 2005 | 40.1 | 4.1 | 44.2 | |
| Loss for the year | - | (3.0) | (3.0) | |
| At 31 March 2006 | 40.1 | 1.1 | 41.2 | |
| At 1 April 2006 | 40.1 | 1.1 | 41.2 | |
| Profit for the year | - | 14.9 | 14.9 | |
| At 31 March 2007 | 40.1 | 16.0 | 56.1 | |

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

22 Notes to the cash flow statement

| Cash flow from operating activities | 2007 £m | 2006 £m |
|---|--------------|--------------|
| Continuing operations | | |
| Operating profit and profit on ordinary activities before interest and taxation | 211.7 | 219.5 |
| Increase in provisions | 24.9 | (5.4) |
| Decrease in pension deficit | (6.6) | (6.6) |
| Depreciation charge | 144.6 | 142.0 |
| Depreciation of grants & contributions | (2.4) | (2.2) |
| Increase in stocks | (1.1) | (0.1) |
| Increase in debtors | (34.0) | (12.5) |
| (Decrease)/increase in creditors | (10.9) | 0.9 |
| Increase in deferred revenue | 17.5 | - |
| Total net cash inflow from operating activities | 343.7 | 335.6 |

Analysis of Net Debt:

| | At 1 April 2006 £m | Cash flows £m | Other non-cash £m | 31 March 07 £m |
|--------------------------|--------------------------|---------------------|-------------------------|----------------------|
| Cash | 247.3 | 26.0 | - | 273.3 |
| Bank overdraft | (13.3) | 3.0 | - | (10.3) |
| | 234.0 | 29.0 | - | 263.0 |
| Debt due within one year | (7.5) | - | - | (7.5) |
| Debt due after one year | (2,797.0) | (234.1) | (24.3) | (3,055.4) |
| Net Debt | (2,570.5) | (205.1) | (24.3) | (2,799.9) |

23 Pensions

The Group accounted for pension costs during the year under FRS17. These disclosures show a net FRS 17 deficit (after deferred tax) of £72.8m (2006 deficit £96.6m). The deficit has arisen mainly as a result of lower expected future returns on investments and turbulence in the stock market. The movement in the deficit is mainly due to changes in actuarial assumptions (financial and demographic) in the year. These movements are analysed below.

Pension schemes operated

At 1 April 2006 the Group principally operated two schemes, details of which are shown below.

- 1 Southern Water Pension Scheme (SWPS), a funded defined benefit scheme, which was closed to new members in 31 December 1998 but re-opened in July 2003 and finally closed to new entrants on 1 April 2005. This scheme has nine trustee directors.
- 2 A second company stakeholder scheme, which is a defined contribution scheme, is also available to all employees.

The assets of the schemes are held separately from those of the Group. State Street Bank and Trust Company acts as custodian for the defined benefit schemes and asset management is delegated to external fund managers.

Contributions made to the scheme for the year to 31 March 2007 amounted to £0.2m.

No contributions were outstanding at the year end.

Members of all schemes receive an annual statement of their accrued benefits.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

23 Pensions (continued)

Pension schemes operated

The latest actuarial valuations of the Southern Water Pension Scheme (SWPS) and Southern Water Services Executive Pension (SWEPS) schemes were carried out as at 31 March 2004 using the projected unit method. The assumptions that have the most significant effect on the results of the valuation are those relating to the rate of return on investments, the rate of future pensionable salary increases and the level of pension increases.

For closed schemes under this method the current service cost will increase as the members of the schemes approach retirement.

The principal assumptions made by the actuary in the valuation were as follows:

| | 2004 SWPS % pa | 2004 SWEPS % pa |
|--|----------------------|-----------------------|
| Return on investments | 6.3 | 5.6 |
| Salary growth | 4.3 | 4.3 |
| Pension increases on the excess over guaranteed minimum pensions | 2.8 | 2.8 |

The assets of the scheme had a market value of £270.4m for the SWPS and £21.9m for the SWEPS at 31 March 2004. This was sufficient to cover 78% and 82% of the benefits of SWPS and SWEPS respectively, that had accrued to members at that date, after allowing for expected future increases in earnings.

FRS 17 - assumptions, asset, liability and reserves disclosures

Formal actuarial funding valuations of the two principal defined benefit schemes in the UK were carried out at 1 April 2004 and updated to 31 March 2006 by a qualified independent actuary. The following disclosures are combined for the SWPS and SWEPS. The major assumptions used by the actuary are set out in the table below:

| | 2006 % pa | 2005 % pa | 2004 % pa |
|--|--------------|--------------|--------------|
| Price inflation | 3.0 | 2.9 | 2.9 |
| Rate of increase in salaries (plus an age-related promotional scale) | 4.3 | 4.4 | 4.4 |
| Rate of increase of pensions in payment | 3.0 | 2.9 | 2.9 |
| Rate of increase for deferred pensions | 3.0 | 2.9 | 2.9 |
| Discount rate | 5.0 | 5.5 | 5.6 |
| Expected return on assets | 6.8 | 7.0 | 7.2 |

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

23 Pensions (continued)

FRS 17 - assumptions, asset, liability and reserves disclosures

The assets and liabilities in the schemes and the expected rates of return at 31 March 2007, 31 March 2006 and 31 March 2005 were

| | Rate of return 2007 % | Rate of return 2006 % | Rate of return 2005 % | Value at 2007 £m | Value at 2006 £m | Value at 2005 £m |
|-----------------------------------|--------------------------------|--------------------------------|--------------------------------|------------------------|------------------------|------------------------|
| Equities | 8.0 | 7.9 | 8.1 | 309.4 | 273.3 | 223.5 |
| Bonds | 4.7 | 4.2 | 4.7 | 97.4 | 108.7 | 94.1 |
| Cash | 5.1 | 4.0 | 3.9 | 3.1 | 5.5 | 7.5 |
| Total market value of Plan assets | | | | 409.9 | 387.5 | 325.1 |
| Total value of Plan liabilities | | | | (513.9) | (525.5) | (465.1) |
| Accrued deficit in the Plan | | | | (104.0) | (138.0) | (140.0) |
| Related deferred tax asset | | | | 31.2 | 41.4 | 42.0 |
| Net pension liability | | | | (72.8) | (96.6) | (98.0) |

Analysis of amounts charged to operating profit:

| | 2007 £m | 2006 £m |
|-----------------------------------|------------|------------|
| Employer's current service cost | 7.8 | 7.1 |
| Employer's past service costs | 0.3 | 0.5 |
| Total charged to operating profit | 8.1 | 7.6 |

Analysis of other amounts credited to operating profit:

| | 2007 £m | 2006 £m |
|---------------------------------------|------------|------------|
| Gain on curtailment | (2.3) | (2.5) |
| Net gain credited to operating profit | (2.3) | (2.5) |

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

23 Pensions (continued)

Analysis of the amount charged to other finance expense:

| | 2007 £m | 2006 £m |
|--|------------|------------|
| Interest on pension scheme liabilities | 26.2 | 25.5 |
| Expected return on pension scheme assets | (26.2) | (22.9) |
| Net charge to other finance expense | - | 2.6 |
| Total charge before tax | 5.8 | 7.7 |

Analysis of the amounts recognised in STRGL:

| | 2007 £m | 2006 £m |
|--|------------|------------|
| Actuarial return less expected return on pension scheme assets | (3.2) | 39.7 |
| Experience gain arising on scheme liabilities | 7.1 | 4.6 |
| Gain/loss on change of assumptions (financial and demographic) – see note (i) below | 23.5 | (46.3) |
| Total gain/(loss) recognised in STRGL before adjustment for tax | 27.4 | (2.0) |

Analysis of the movement in the schemes' deficits during the year

| | 2007 £m | 2006 £m |
|--------------------------------------|------------|------------|
| Deficit in the scheme at 1 April | (138.0) | (140.0) |
| Employer's contributions | 12.4 | 11.7 |
| Employer's current service cost | (7.8) | (7.1) |
| Employer's past service cost | (0.3) | (0.5) |
| Curtailment gain | 2.3 | 2.5 |
| Other finance expense | - | (2.6) |
| Actuarial gain/(loss) | 27.4 | (2.0) |
| Deficit in the scheme at end of year | (104.0) | (138.0) |

Notes

(i) Approximate breakdown of gain/loss due to change in assumptions

| | 2007 £m | 2006 £m |
|--|------------|------------|
| Impact of | | |
| Change in financial assumptions - see note (a) | 20.9 | (46.3) |
| Change in demographic assumptions - see note (b) | (15.0) | - |
| Introduction of explicit commutation allowance | 17.6 | - |
| | 23.5 | (46.3) |

- a) Reflects significant strengthening of financial basis from 31 March 2005 to 31 March 2006, and weakening from 31 March 2006 to 31 March 2007
- b) Reflects introduction of allowance for increased longevity, increasing liabilities by 3%

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

23 Pensions (continued)

Details of experience gains and losses for the year to 31 March 2007 are as follows:

| | 2007 | 2006 | 2005 | 2004 |
|---|--------|--------|--------|--------|
| a Actuarial (gain)/loss on scheme assets | | | | |
| Amount (£m) | 3.2 | (39.7) | (19.2) | (34.0) |
| Percentage of the scheme assets | 0.8% | 10.2% | 5.9% | 11.9% |
| b Experience (gain)/loss on scheme liabilities | | | | |
| Amount (£m) | (7.1) | (4.6) | (1.8) | 6.8 |
| Percentage of the present value of the scheme liabilities | 1.4% | 0.9% | 0.4% | 1.6% |
| c Total actuarial (gain)/loss recognised in STRGL | | | | |
| Amount (£m) | (27.4) | 2.0 | (13.1) | 0.3 |
| Percentage of the present value of the scheme liabilities | 5.3% | 0.4% | 2.9% | 0.1% |

24 Contingent liabilities

| | Group 2007 £m | Group 2006 £m |
|---------------------|---------------------|---------------------|
| Contractors' claims | 1.9 | 1.9 |

Contractors submit claims to SWS for the estimated final cost of their works. These claims are reviewed to assess where the liability for the costs rests and the amount that will actually be settled. The expected amount is included within capital creditors and a further sum is identified as a contingent liability, representing a proportion of the difference between the contractor's claim and SWS's valuation.

25 Financial commitments

| | Group 2007 £m | Group 2006 £m |
|---|---------------------|---------------------|
| Annual commitments under other operating leases | | |
| Expiring within one year | 0.4 | 0.4 |
| Expiring between two and five years | 2.2 | 2.7 |
| | 2.6 | 3.1 |

Operating leases are charged to the Profit and Loss Account over the lease term.

The Company has no such commitments.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

26 Directors' emoluments

| | 2007 £000 | 2006 £000 |
|---|--------------|--------------|
| Aggregate emoluments (including benefits in kind) | 152.7 | 203.7 |

Directors' emoluments relate to amounts paid by Southern Water Services Limited for their services to that company

No payments were made to the directors of Southern Water Capital Limited by the company as they are deemed to be of a non-executive nature

27 Related party transactions and ultimate controlling party

The major shareholders in Southern Water Capital Limited at 31 March 2007 are Royal Bank Investments Limited and PPI Investments SP Inc. As at 1 April 2006, Southern Water Capital owned 75.0% of the share capital of Southern Water Investments Limited. The remaining 25.0% was owned by Veolia Water Investment Limited (VWIL). The Company acquired VWIL's entire shareholding on the 10 April 2006.

The transactions and balances with the Group's related parties, as defined by Financial Reporting Standard 8 and the extent of the transactions with them are summarised below:

| | 2007 £m | 2006 £m |
|--|------------|------------|
| - | - | - |
| Turnover | | |
| Recharges for consultancy to Veolia Water UK plc | - | 0.1 |
| Costs | | |
| Royal Bank Investments Limited | | |
| - fees in respect of the debt issued | 3.3 | 2.5 |
| Veolia Water UK plc | | |
| - preference dividends paid | - | 1.6 |
| - ordinary dividends paid | - | 1.0 |
| Renex Limited | | |
| - consultancy fees for R Thian | - | 0.1 |
| Creditors | | |
| Management charges payable to Veolia Water Investment Limited and Royal Bank Investments Limited | - | 0.2 |
| Loans greater than one year | | |
| Loans from Royal Bank Investments Limited | 510.8 | 233.2 |

Other related party transactions

Les Dawson, a director of Southern Water Services Limited, the principal trading subsidiary of Southern Water Capital Limited, was granted 44,000 shares in Southern Water Capital Limited out of the holding of Royal Bank Investments Limited in the year, for services to Southern Water Capital Limited.

No cost has been included in the accounts under FRS 20 "Share based payments" as the amount is considered immaterial and no recharge or cost to the group has been made or incurred.

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

28 Principal subsidiaries

As at 31 March 2007 the Company held 100% of the ordinary share capital of Southern Water Investments Limited. Southern Water Investments Limited principal subsidiaries are listed below

| Company | Class of share capital | Proportion of shares held | Activity |
|--|------------------------|---------------------------|--|
| Southern Water(NR) Holdings Limited | Ordinary | 100% | Non-trading activities |
| Southern Water(NR) Limited (formerly Aspen 4 Limited) | Ordinary | 100% | Non-trading activities |
| SWS Group Holdings Limited | Ordinary | 100% | Non-trading activities |
| SWS Holdings Limited | Ordinary | 100% | Non-trading activities |
| Southern Water Limited (formerly Southern Water plc) | Ordinary | 100% | Intermediate parent company for Southern Water(NR) Group |
| Southern Water Services Limited | Ordinary | 100% | Supply of Water and Wastewater Services |
| Southern Water Services Finance Limited | Ordinary | 100% | To raise debt finance |
| Southern Water Services Group Limited | Ordinary | 100% | Non-trading activities |
| Southern Water Industries Limited | Ordinary | 100% | Commercial Services |
| Southern Water Services Finance plc | Ordinary | 100% | Financial Services |
| Bowsprit Holdings Limited | Ordinary | 100% | Property Investment |
| Monk Rawling Limited | Ordinary | 100% | Estate Management |
| Bowsprit Property Development Limited | Ordinary | 100% | Property Development |
| James Leppard & Sons Limited | Ordinary | 100% | Landfill Operator |
| Taylor Plant & Haulage Limited | Ordinary | 100% | Landfill Operator |
| EcoClear Limited | Ordinary | 100% | Dormant |
| Southern Water Executive Pension Scheme Trustees Limited | Ordinary | 100% | Corporate Trustee of Executive Pension Scheme |
| Southern Water Pension Trustees Limited | Ordinary | 100% | Corporate Trustee of Company Pension Scheme |

All subsidiaries have been included in Southern Water Capital Limited's consolidated accounts

Associate Company

| | | | |
|--|----------|-----|--|
| Coastal Wastewater Consultants Limited | Ordinary | 50% | Marine treatment, engineering design and consultancy |
|--|----------|-----|--|

This company has not been consolidated in the financial statements due to immateriality

SOUTHERN WATER CAPITAL LIMITED

NOTES TO THE CONSOLIDATED ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

29 Post Balance sheet events

During June 2007, the owners of the Southern Water group of companies indicated that they would be looking to dispose of their interest in the group and are actively seeking buyers

On 5 July 2007, Royal Bank Investments Limited acquired the entire shareholding of PPI Investments SP Inc and DE Shaw in SWC, representing 49% of the voting shares, increasing their shareholding to 97.9% of the voting shares

In September 2007, the group was given confirmation of the regulator's intention to impose a fine for the historical failure to meet customer service standards and the misreporting of customer services data. Consequently, a provision of £25.0m has been included in the accounts to 31 March 2007

SOUTHERN WATER CAPITAL LIMITED

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SOUTHERN WATER CAPITAL LIMITED

We have audited the Consolidated and Company financial statements (the "financial statements") for the year ended 31 March 2007 which comprise the Consolidated Profit and Loss Account, the Consolidated and Company Balance Sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Total Recognised Gains and Losses and the related notes. These financial statements have been prepared under the accounting policies set out therein.

Respective responsibilities of directors and auditors

As described in the Statement of Directors' Responsibilities the company's directors are responsible for the preparation of the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. We also report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the Directors' Report and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

SOUTHERN WATER CAPITAL LIMITED

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SOUTHERN WATER CAPITAL LIMITED (continued)

Opinion

In our opinion

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Group and Company's affairs as at 31 March 2007 and of its Group profit and Group cash flows for the year then ended,
- the financial statements have been properly prepared in accordance with the Companies Act 1985, and
- the information given in the Directors' Report is consistent with the financial statements



PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Gatwick 3 OCTOBER 2007